HOLDING THE ENABLERS RESPONSIBLE: APPLYING SEC RULE 10B-5 LIABILITY TO THE CREDIT RATING INSTITUTIONS

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I. INTRODUCTION

In 1942, the Securities and Exchange Commission (SEC) formulated a Rule to protect against disingenuous representations made in connection with securities trading: SEC Rule 10b-5.[1] The Rule was adopted in reaction to a very specific situation not addressed by the securities laws—a company president had purposely driven down the price of his company's shares before the release of a favorable earnings report to manufacture a better return.[2] Yet, at its core, Rule 10b-5 had a much larger purpose—to ward off the type of market manipulation that led to the 1929 stock market crash.[3] Since then, the scope of the Rule has grown immensely to become a "catch-all" clause to prevent the use of "manipulative devices" in conjunction with securities trading.[4]

Today, credit rating agencies face similar perverse incentives to make disingenuous representations that manipulate securities trading. Securities issuers have the ability to "shop" for more favorable ratings in order to make their products as lucrative as possible, and the ratings agencies are paid handsomely to participate. In fact, such reckless appraisals by these agencies were a significant catalyst in the recent financial crisis.[5] Former

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1. 17 C.F.R. § 240.10b-5. Part (b) of Rule 10b-5 makes it unlawful to make any untrue statements of material fact or to omit material facts necessary in order to make statements not misleading.

2. Jonn R. Beeson, Comment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077, 1107 (1996).

3. *Id.*

4. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976) (citing Congressional testimony by one of the drafters that "[t]he section was described rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative [or cunning] devices.'").

5. The ratings agencies "played a crucial role in the epochal housing market collapse, affixing their most laudatory grades to billions of dollars worth of bonds that went bad in the

Ohio Attorney General Richard Cordray even went as far as to state that the agencies' "total disregard for the life's work of ordinary Ohioans caused the collapse of our housing and credit markets and is at the heart of what's wrong with Wall Street today."[6]

Problematically, no mechanisms are being utilized to hold these agencies liable for the damages they have encouraged. Much like the more pedestrian book and movie reviews, credit rating agencies and their investment recommendations command broad First Amendment free speech protections, which have shielded them from liability.[7] But the instances in which these assessments turned out to be false, damaging, and reckless can no longer be ignored. These are not statements of mere opinion that deserve First Amendment protections, but are instead carefully reasoned representations made for the explicit purpose of industry reliance. Rule 10b-5 naturally applies to police such ratings and should be used immediately to prosecute material misrepresentations made by the ratings agencies.

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subprime crisis." David Segal, *Debt-Rating Agencies Avoid Broad Overhaul After Crisis*, N.Y. TIMES, Dec. 8, 2009, at A1. *See also* Caitlin M. Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors*, 50 B.C. L. REV. 1275, 1288-89 (2009) ("Although many participants share responsibility for the crumbling financial market, regulators have cited credit ratings in general and credit rating agencies in particular, as having failed the marketplace."); Amanda Bahena, *What Role Did Credit Rating Agencies (CRAs) Play in the Financial Crisis?*, (unpublished poster presentation, University of Iowa Center for International Finance and Development), *available at* http://www.uiowa.edu/ifdebook/issues/financial_crisis/posters/Amanda%20Final%20Draft.pdf (containing a detailed analysis of the Credit Rating agencies as a crucial industry mechanism).

6. Segal, *supra* note 5.

7. *See* Milkovich v. Lorain Journal Co., 497 U.S. 1, 20 (1990) (holding that "a statement on matters of public concern must be provable as false before there can be liability under state defamation law, at least in situations . . . where a media defendant is involved," although, reserving judgment on cases involving non-media defendants); Roth v. United States, 354 U.S. 476, 484 (U.S. 1957) ("The protection given speech and press was fashioned to assure unfettered interchange of ideas for the bringing about of political and social changes desired by the people."); *see also* Lowe v. SEC, 472 U.S. 181, 210 (1985) ("To the extent that the chart service contains factual information about past transactions and market trends, and the newsletters contain commentary on general market conditions, there can be no doubt about the protected character of the communications . . . ."); Abood v. Detroit Bd. of Educ., 431 U.S. 209, 231 (1977) (stating that the purpose of the First Amendment was to protect free discussion); Time, Inc. v. Hill, 385 U.S. 374, 388 (1967) (precluding redress under a false reporting statute in the absence of proof that the defendant published the report with knowledge of falsity or in reckless disregard of the truth). *But cf.* Valentine v. Chrestensen, 316 U.S. 52, 54 (1942) (providing an example of the Supreme Court severely curtailing commercial free speech by holding that "the Constitution imposes no such restraint on government as respects purely commercial advertising . . . . [T]o what extent such activity shall be adjudged a derogation of the public right of user, are matters for legislative judgment.").

As our financial markets struggle to recover from near-collapse, Rule 10b-5 can fill a regulatory void by confronting and deterring some of the reckless behavior that put the American economy into its current predicament. Such statements by ratings agencies are sufficiently material to extend beyond mere expressions of opinion, and the SEC certainly retains jurisdiction to enforce this Rule against the rating agencies. I will argue that there is no inherent reason to protect these for-profit appraisals with the protections of the First Amendment, and that strong public policy considerations demand that Rule 10b-5 be given full effect against these agencies.[8]

II. PERVERSE INCENTIVES

Ratings necessarily make a particular investment more or less attractive. This creates perverse incentives that are not currently counterbalanced by any consistent threat of liability, other than from outright fraud when it exists and can be proven.[9] It is therefore important to recognize that these disastrous miscalculations were not mere unfortunate accidents, but exactly the sort of chaos that would be expected to materialize from such a skewed incentive structure. This potential conflict has been flagged before:

> Without question, the credit rating system is one of the capitalism's strangest hybrids: profit-making companies that perform what is essentially a regulatory role. The companies serve the public, which expect them to stamp their imprimatur on safe securities and safe securities alone. But they also serve their shareholders, who profit whenever that imprimatur shows up on a security, safe or not.[10]

In fact, the problem is best illustrated through the practice of "rate shopping," where the issuing party of a security will solicit several rating agencies in an attempt to secure the most lucrative rating possible.[11] This

8. "[C]redit rating agencies have used the [First Amendment] privilege more effectively than any other gatekeeper, to avoid not only liability but also regulatory scrutiny." Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers, at* 88 (Univ. of San Diego Legal Studies Research Paper Series, Research Paper No. 07-46, May 2006), *available at* http://ssrn.com/abstract=900257.

9. *See* Gretchen Morgenson, *House Panel Scrutinizes Rating Firms*, N.Y. TIMES, Oct. 23, 2008, at B1 (attributing the "disastrous performance of credit rating agencies in assessing the risks of mortgage-backed securities" to inherent conflicts of interest in the business model, according to former officials at Moody's Investors Service and Standard & Poor's).

10. Segal, *supra* note 5.

11. *See generally* Sarah N. Lynch, *SEC Chief Targets the Credit Raters*, WALL ST. J., July 15, 2009, at C10 (detailing SEC's interest in proposals to curb conflicts of interest and

practice makes explicit the erosion of agency objectivity in the pursuit of profitability. At the very least, such a system encourages companies to err in favor of providing more favorable ratings, but at its worst, encourages outright fraud and deception.

Even the agency analysts themselves acknowledged the problems stemming from such skewed incentives, but business continued perilously as usual. In one now-infamous email, a Standard & Poor's (S&P) employee wrote to a co-worker that a particular investment they were rating was "ridiculous" and that they "should not be rating it," to which the co-worker retorted that "we rate every deal" and that "it could be structured by cows and we would rate it."[12]

Former SEC Chairman Arthur Levitt, Jr. brought this problem to the nation's attention back in 2007:

> Now, investors are relying on credit ratings to make informed investment decisions, but the credit rating firms are paid not by investors but by the companies they rate. And as complex, structured debt products have increased in popularity, the relationship between rater and issue became even closer—and the line between independent rater and paid advisor became blurred. This very circumstance suggests that a potential conflict of interest—between providing objective ratings and satisfying their corporate clients may be distorting the rating agencies' judgment. That they are both coach and referee.[13]

SEC Chairman, Christopher Cox, agreed that the agencies were faced with a "triple-A conflict of interest":

> [I]t was well understood that certain conflicts of interest were hardwired into the rating agency business model. But we have learned since then that the ratings of structured products in the subprime area made those conflicts of interest even more acute. That's because structured products were specifically designed for each tranche to achieve a particular credit rating—and the ratings agencies then made a lucrative business of consulting with issuers on exactly how to go about getting those ratings. Selling consulting services to entities that purchased ratings became a

improve transparency and accountability by ratings companies, including ways to end the practice of issuers "shopping" for the best ratings).

12. Aaron Lucchetti, *Internal S&P Emails Derided Ratings Rush*, SMARTMONEY, Aug. 4, 2009, http://www.smartmoney.com/breaking-news/smw/?story=20080804091712. In another instance, "an analytical manager in the collateralized debt obligations group at S&P told a senior analytical manager in a separate email that 'rating agencies continue to create' an 'even bigger monster--the [Collateralized Debt Obligation] market. Let's hope we are all wealthy and retired by the time this house of cards falters . . . .'" *Id.*

13. Arthur Levitt Jr., Former Chairman, U.S. Sec. and Exch. Comm'n, *Strengthening the Gatekeepers: The Importance of Independence and Accountability to the Capital Markets*, Luncheon Address to the Ontario Sec. Comm'n (Nov. 27, 2007).

triple-A conflict of interest.[14]

The recent case *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.* offers an especially egregious example of this conflict of interest at work.[15] There, the accused ratings agency worked to package securities in such a way as to reverse-engineer a "top rating" for the benefit of the investment's marketability.[16] Even more astonishing, their compensation for doing so was over three times the going rate and was "contingent upon the receipt of desired ratings . . . and only in the event that the transaction closed with those ratings."[17] In other words, the agency was being paid to manufacture a specific rating, not to objectively rate the security. The court acknowledged that the conflict of interest was not inherently dispositive of "knowingly" making a "false or misleading statement."[18]

> But where both the Rating Agencies and Morgan Stanley knew that the ratings process was flawed, knew that the portfolio was not a safe, stable investment, and knew that the Rating Agencies could not issue an objective rating because of the effect it would have on their compensation, it may be plausibly inferred that Morgan Stanley and the Rating Agencies knew they were disseminating false and misleading ratings.[19]

Abu Dhabi Commercial Bank has offered some very limited advancements against the impunity of the ratings agencies, in theorizing that such appraisals may not be subject to protection when they are made for the benefit of very specific audiences.[20] I will expand on this theory by arguing that Rule 10b-5 provides, on the whole, a more complete, reliable,

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14. Christopher Cox, Chairman, U.S. Sec. and Exch. Comm'n, Statement at Open Meeting on Rules for Credit Rating Agencies (June 11, 2008), *available at* http://www.sec.gov/news/speech/2008/spch061108cc.htm.

15. Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155 (S.D.N.Y. 2009).

16. *Id.* at 166-67. In fact, these were the highest ratings ever given to that particular sort of security to date. *Id.* at 165.

17. *Id.* at 167.

18. *Id.* at 178-79.

19. *Id.* at 179.

20. *First Equity Corp. v. Standard & Poor's Corp.* held that:

> It is widely recognized that in the absence of a contract, fiduciary relationship, or intent to cause injury, a newspaper publisher is not liable to a member of the public for a non-defamatory negligent misstatement of an item of news, "unless he wilfully . . . circulates it knowing it to be false, and it is calculated to and does . . . result in injury to another person."

670 F. Supp. 115, 117 (S.D.N.Y. 1987) (quoting 58 American Jurisprudence 2d Newspapers, Periodicals & Press Assns. § 22 (1971)); *see also Judge Rejects Credit Rating Firms' Free-Speech Claims*, WALL ST. J. L. BLOG, (Sept. 3, 2009, 6:49 PM ET), http://blogs.wsj.com/law/2009/09/03/judge-rejects-credit-rating-firms-free-speech-claims/ (commenting on the *Abu Dhabi* decision).

and established method for attack in situations where the ratings are not outright fraudulent. With great power comes great responsibility, and Rule 10b-5 would couple the immense economic power of the rating agencies with corresponding liability and deterrence.[21] Moreover, when suspicious ratings do become the subject of litigation, the burden would be turned on to the rating agency to substantiate that the rating was not recklessly made.

III. THE AMERICAN ECONOMY RELIES ON RATING AGENCIES

In today's complex economy, consumers are forced to rely on expert ratings when investing in highly complicated financial products. In fact, using rating agencies is often a requirement:[22] "[s]tatutes and rules require that mutual fund and money managers of almost every stripe buy only those bonds that have been given high grades by a Nationally Recognized Statistical Rating Organization . . . ."[23]

Such regulations fuel a particularly dangerous cycle, extending more favorable regulatory treatment to credit rating agencies while "prohibit[ing] many of the biggest purchasers of bonds, like pension funds, insurance companies, and banks, from purchasing low or unrated debt and, as a consequence, increas[ing] the demand for ratings."[24] While the aim of such restrictions is to make sensitive investments more secure, they have created a perverse incentive for the agencies to capture the "voracious" appetite of these major investors.[25]

Distressingly, the sorts of funds that are required to stick to top rated investments are often those relied upon for vital civic purposes such as pension and retirement funds, university endowments, municipal bonds, and other governmental services.[26] While these are precisely the sort of

21. It is also a more uniform method. State law may allow similar lawsuits to go forward, but this is currently a state-by-state determination, subject to strategizing.

22. *See* SEC, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, at 8 (Jan. 2003), *available at* http://www.sec.gov/news/studies/credratingreport0103.pdf (providing examples of Congress incorporating the Nationally Recognized Statistical Rating Organizations into a variety of financial legislations).

23. Segal, *supra* note 5.

24. Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111, 1117 (2009); *see generally* Sec. & Exch. Comm'n Report, *supra* note 22 (explaining the "[i]mportance of the Role of Credit Rating Agencies to Investors and the Functioning of the Securities Markets").

25. *See* Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 281 (2009) ("Yet, instead of being punished, the credit rating agencies were rewarded by the marketplace; institutional investor appetite for mortgage-backed securities and CDOs based on them increased voraciously until 2007, and the major credit rating agencies profited handsomely as a result.").

26. *See id.* at 244 (citing U.S. SEC, Report On The Role And Function Of Credit

investments that require the most stability, the credit rating agencies have an incentive to inflate ratings in order to sell these entities debt that they would otherwise be restricted from purchasing.[27] In relying on such ratings, these funds were unaware of the amount of risk they were actually assuming, and a "House of Cards" was built, primed for collapse.[28]

IV. CURRENT LIABILITY FOR AGENCIES

The current First Amendment standard requires real fraud in light of established First Amendment protections.[29]

In a wide array of circumstances, state and federal courts have consistently recognized that S&P and other rating agencies are entitled to the same First Amendment protections as other financial publishers such as BusinessWeek and The Wall Street Journal. These decisions have been based on widespread judicial recognition that, at their core, rating agencies perform First Amendment functions by gathering information, analyzing it and disseminating opinions about it—in the form of credit ratings and commentary—to the general public.[30]

From a policy perspective, the fear is that excessive restrictions on these ratings would have a chilling effect on investment recommendations. This would, in turn, deprive investors of the very information they need to manage risk:

> Courts cannot constitutionally allow recovery on any showing less than recklessness because of the potential chilling effect that imposing a negligence standard would have on rating

Ratings Agencies In The Operation Of The Securities Markets, at 41-42 (2003)). "Many institutional investors, pursuant to regulations, are forbidden or discouraged from purchasing certain low rating securities. Federal and state regulators, as well as international organizations, often adopt the credit rating agencies' ratings in order to determine the creditworthiness and credit risk of assets held by certain regulated entities, such as commercial banks and insurance companies, and the minimum capitalization requirements for these entities." *Id.*

27. *See* Franklin Sav. Bank v. Levy, 551 F.2d 521, 527 (2d Cir. 1977) (concerning "an institution authorized by statute only to invest in prime paper").

28. *See* WILLIAM D. COHAN, HOUSE OF CARDS (2009) (detailing the events leading up to the financial crisis).

29. "It is well-established that under typical circumstances, the First Amendment protects rating agencies, subject to an 'actual malice' exception, from liability arising out of their issuance of ratings and reports because their ratings are considered matters of public concern." *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*, 651 F. Supp. 2d. 155, 175 (S.D.N.Y. 2009). Of course, state law causes of action can go forward where there is actual fraud or misrepresentation. *See, e.g.*, Quinn v. McGraw-Hill Cos., 168 F.3d 331, 336 (7th Cir. 1999) (finding no negligent misrepresentation on behalf of the ratings agency under state law, due to lack of reasonable reliance).

30. Standard & Poor's "Exhibit 2" document (on file with the author) (providing an example of such opinion).

> publications. Given the importance of financial information to investors and the economy as a whole, bond rating constitutes a matter of "public concern." Applying traditional [F]irst [A]mendment law, the state's interest in compensating relying investors must give way to the [F]irst [A]mendment's concern for the free flow of commercial information. Society must rely on the market and competition to keep rating agencies operating at their negligence threshold, not on courts and juries.[31]

As will be established later, "recklessness" does in fact seem to be a fair and workable standard. Yet, in light of the sentiments laid out above, credit agencies have commanded vast free speech protection, being held to the "actual malice standard."[32] Following this, courts have been reluctant to go any further due to the allegedly opinionated, free speech nature of such ratings.[33]

An example of this is in *Compuware Corp. v. Moody's Investors Services*, a case in which a computer corporation alleged defamation stemming from what it perceived was an unduly negative credit rating it received for its business.[34] Beyond finding no actual malice on the part of the rating agency,[35] the court further found no defamation, holding that a "credit rating is a predictive opinion, dependent on a subjective and discretionary weighing of complex factors" and that there was "no basis upon which we could conclude that the credit rating itself communicates any provably false factual connotation."[36]

Similarly, in the case of *Jefferson County School District v. Moody's Investor's Services, Inc.*, the court found no injury for a credit rating agency's appraisal giving a generally bad outlook for the school system's

31. Gregory Husisian, Note, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 410, 460 (1990).

32. County of Orange v. McGraw Hill Cos., 245 B.R. 151, 156 n.4 (C.D. Cal. 1999).

33. "[A] statement of opinion relating to matters of public concern which does not contain a provably false factual connotation will receive full constitutional protection." *Milkovich v. Lorain Journal Co.*, 497 U.S. 1, 20 (1990). However, this does not appear to cover all matters of opinion. "Stated another way, the Court immunized only pure, *evaluative* opinion. Thus, a pure *deductive* opinion, which is provable as true or false on the basis of objective evidence, carries no immunity." Kathryn Dix Sowle, *A Matter of Opinion: Milkovich Four Years Later*, 3 WM. & MARY BILL RTS. J. 467, 474 (1994). The latter conceptualization would appear applicable to hold the credit ratings agencies liable.

34. Compuware Corp. v. Moody's Investors Servs., 499 F.3d 520, 524 (6th Cir. 2007) (alleging that Moody's downgrade of Compuware's ratings were unjustified).

35. *Id.* at 528 (applying an "actual malice standard"). Actual malice requires "knowledge . . . that it was false or with reckless disregard of whether it was false or not." New York Times Co. v. Sullivan, 376 U.S. 254, 279-80 (1964). In this, while a failure to do due diligence may not be reckless itself, "purposeful avoidance of the truth" is sufficient. Harte-Hanks Commc'ns v. Connaughton, 491 U.S. 657, 692 (1989).

36. *Compuware*, 499 F.3d at 529.

bonds.[37] Here, the court found statements such as "negative outlook" and "ongoing financial pressures" were "too indefinite to apply to a false statement of fact," but that if they were "coupled with specific factual assertions, such statements might not be immunized from defamation claims by the First Amendment."[38] Thus, courts concur that appraisals fall outside First Amendment bounds when such statements transcend vague opinion and take on the contours of fact: "If such an opinion were shown to have materially false components, the issuer should not be shielded from liability by raising the word 'opinion' as a shibboleth."[39]

Such an avenue of attack was implemented in a very recent decision by the Southern District of New York opening the door for the application of 10b-5 to credit rating agencies, *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*[40] Specifically, while the First Amendment has been used to shield agencies claiming that their ratings are matters of public concern, the developing legal theory in *Abu Dhabi Commercial Bank* targeted statements of more limited, private concern.[41] "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 protection."[42] Judge Scheindlin rejected free speech claims where ratings agencies were intimately involved in evaluating a particular investment vehicle.[43] Moreover, the court rejected the agencies' claim that these were non-actionable opinions.[44] Such opinions "may still be actionable if the speaker

37. Jefferson Cnty. Sch. Dist. v. Moody's Investor's Servs., Inc., 175 F.3d 848, 850 (10th Cir. 1999) (affirming district court's dismissal of school district's complaint on the grounds that no relief could be granted).

38. *Id.* at 856.

39. *Id. But see* David Segal, *A Matter of Opinion?*, N.Y. TIMES, July 19, 2009, at BU1 (describing how in pending litigation against financial services company Standard & Poor's, attorney Floyd Abrams will attempt to further this argument that such investment appraisals "deserve exactly the sort of free-speech protections afforded to journalists, on the theory that a bond rating is like an editorial—an opinion based on an educated guess about the future").

40. WALL ST. J. L. BLOG, *supra* note 20.

41. Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155, 175 (S.D.N.Y. 2009) (distinguishing ratings sent to a certain group of investors from ratings available to the general public).

42. *Id. See also* In re Fitch, Inc., 330 F.3d 104 (2d Cir. 2003) (finding that the credit rating agency did not deserve journalist privilege where it was client-driven and actively involved in structuring the underlying transactions). *But see* In re Republic Nat'l Life Ins. Co., 387 F. Supp. 902, 905 (S.D.N.Y. 1975) (granting a Fed. R. Civ. P. 12(b)(6) motion to dismiss where "[t]he moving defendants had no transactions of any kind with the plaintiffs, . . . no duty which was breached," and therefore defendants were "not accountable to plaintiffs under the federal securities laws for their stock speculations" in stating that the public stock was a "good investment").

43. *Abu Dhabi*, 651 F. Supp. 2d at 166 (noting that the ratings agency had a more integral role in the structuring of the security than the typical agency).

44. *Id.* at 176 (holding that the opinions were "actionable misrepresentations").

does not genuinely and reasonably believe [them]"[45] and where the plaintiffs have met the burden of alleging that the agencies did not have sufficient belief in fact to make such appraisals.[46] So far, this is "the first major ruling upholding fraud allegations against an arranger and the rating agencies on the instruments that are at the heart of the financial crisis."[47]

Such a conclusion may have been inevitable, especially in light of recent Supreme Court jurisprudence.[48] *Dun & Bradstreet v. Greenmoss Builders* was a defamation case alleging that a credit reporting agency "grossly misrepresented respondent's assets and liabilities" in a report to its subscribers.[49] There, the court found a "reduced constitutional value of speech involving no matters of public concern," specifically when prepared for a "specific business audience."[50] Moreover, such traditional notions of privity seem easily applicable to credit rating agencies:

> Rating firms . . . could have a hard time claiming free-speech rights if courts construe their ratings of mortgage-backed securities to be akin to private commercial transactions. "The more it looks like [ratings] firms were hired specifically to do this one rating for this one company . . . the less likely it is that the First Amendment will be applied."[51]

While liability in the context of privity is not a radical concept, holding such agencies more generally liable for public statements has not been fully explored. I will argue that privity is not a necessary component for agency liability under Rule 10b-5. The holdings of the cases above, specifically *Abu Dhabi Commercial Bank*, should be applied to the credit rating agencies and the statements they promulgate to the financial markets.

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45. *Id.* (quoting In re IBM Corp. Sec. Litig., 163 F.3d 102, 109 (2d Cir. 1998)).

46. *Id.* Moreover, "disclaimers in the Information Memoranda that '[a] credit rating represents a Rating Agency's opinion regarding credit quality and is not a guarantee of performance or a recommendation to buy, sell or hold any securities,' are unavailing and insufficient to protect the Rating Agencies from liability for promulgating misleading ratings." *Id.*

47. Joel Rosenblatt and David Glovin, Moody's, S&P Lose Free-Speech Bid to End Fraud Suit (Update5), BLOOMBERG (Sept. 3, 2009), http://www.bloomberg.com/apps/news?pid=20601087&sid=aC6m.J60h2Ww (citing securities lawyer Patrick Daniels).

48. *See, e.g.*, In re Nat'l Century Fin. Enters., 580 F. Supp. 2d 630, 640 (S.D. Ohio 2008) (refusing to extend First Amendment protections to a rating that was not issued to the general public. "Rather, the notes were . . . targeted to a select class of institutional investors . . . . And the only place that the ratings are alleged to have appeared were in the offering materials given to the select class of investors.").

49. Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 751 (1985).

50. *Id.* at 761-62.

51. Nathan Koppel, *Credit Raters Plead the First. Will It Fly?*, WALL ST. J., Apr. 21, 2009, at C4 (quoting Larry Ellsworth, former SEC litigator).

V. THE SOLUTION: HOLDING RATINGS AGENCIES LIABLE THROUGH SEC RULE 10B-5.

A broader method of attack against such reckless and damaging ratings is to treat them not as mere opinion, but to hold them as legal actions, specifically as "manipulative and deceptive devices" under SEC Rule 10b-5, section (b).[52] Rather than limiting complaints to the terms of malicious fraud or misrepresentation, this would allow a finding of fact to shift the burden of proof to the defendant (the credit rating agency) to substantiate its rating with an adequate basis in fact and show that it was not recklessly made.

The original aim of SEC Rule 10b-5 was to prevent corporate representatives from making false statements intended on moving the market. Specifically, it was targeted at "insiders who remained silent about a company's position when trading while in the possession of material nonpublic information . . . ."[53] In response to a very specific situation, the rule was crafted in a hurried fashion and in broad language.[54] Yet, as an unintended consequence, the language, which remains unchanged to this day, has "become the 'catch-all' provision for fraud."[55] Moreover, as will be shown, Rule 10b-5 extends naturally to the credit rating agencies.

This line of attack appears to be explicitly endorsed by the recent Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010.[56] That Act allows a Rule 10b-5 claim against a ratings agency to go forward

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52. SEC Rule 10b-5 reads:

> "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,
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> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."
>
> (codified at 17 C.F.R. § 240.10b-5, per 15 U.S.C. 78j(b)).

53. Beeson, *supra* note 2, at 1107.

54. *Id.* For an insider's account of Rule 10b-5's inception, *see* Michael H. Dessent, *Weapons to Fight Insider Trading in the 21st Century: A Call for the Repeal of Section 16(b)*, 33 AKRON L. REV. 481, 486-87 (2000) (supporting repeal of Exchange Act § 16(b), which targets so-called "short swing" profits).

55. Beeson, *supra* note 2, at 1107. "Consequently, section 10(b)'s generality has meant that its substance comes from the ad hoc adjudication of the courts and the SEC." *Id.* at 1108.

56. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §933, 124 Stat. 1376 (2010).

where the agency cannot prove that its ratings of a security were made with sufficient precision.[57] This alone is strong evidence that credit ratings agencies fall squarely within the purview of Rule 10b-5.

Specifically, a proper Rule 10b-5 claim requires a) scienter; b) as to a material misrepresentation; c) reliance on that misrepresentation; d) in connection with the purchase or sale of a security; and e) actual economic loss or loss causation.[58] These elements will be set out below as applied to the credit rating agencies. I will not address the final element of a loss requirement, considering that an economic loss would need to exist to drive litigation in the first instance.

As a preliminary matter, Section 10b-5 liability requires that the misleading statement must be made "in connection with the purchase or sale of any security."[59] Section 3 of the 1934 Act provides that the term "sale" shall "include any contract to sell or otherwise dispose of [securities]."[60] Subsequent case law has been helpful in clarifying this requirement.

Blue Chip Stamps v. Manor Drug Stores adopted the "Birnbaum" rule that "the plaintiff class for purposes of a private damage action under § 10(b) and Rule 10b-5 was limited to actual purchasers and sellers of securities."[61] However, this is not as stark of a rule as it may seem.[62] The limitation only applies to private actions under 10b-5,[63] and it has been explicitly held as so limited. Additionally, the Supreme Court recently stated that "[u]nder [its] precedents, it is enough that the fraud alleged

57. Specifically, a motion to dismiss will not be granted where the "agency has not, generally speaking, alleged facts concerning the agency's failure to reasonably investigate or verify the information on which the agency's rating is based." Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1666 (2010). The standard imposed in the Act would be knowing or reckless failure to: "(i) to conduct a reasonable investigation of the rated security 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 (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." Pub. L. No. 111-203 at § 933(b).

58. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005).

59. 17 C.F.R. § 240.10b-5.

60. 15 U.S.C. § 78c(a)(14).

61. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (citing Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir. 1952)).

62. *See* Virginia Bankshares v. Sandberg, 501 U.S. 1083, 1091-92 (1991) (finding the *Blue Chip Stamps* standard to be "instructive" for "illustrating a line between what is and is not manageable in the litigation of facts" and finding that director statements of opinion did not "implicate [such] concerns").

63. *See* Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) (stating that "it is now established that a private right of action is implied under § 10(b)"). *See also Blue Chip Stamps*, 421 U.S. at 727 (delineating the contours of this judicially created private cause of action).

'coincide' with a securities transaction--whether by the plaintiff or by someone else."[64] Thus, at the very least, there is no such restriction on the SEC for enforcement of 10b-5 against the credit rating agencies, though private actions appear to extend more broadly as well.[65]

In *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, the plaintiff alleged that broker Merrill Lynch, with the aim of benefitting its customers, had unfairly driven up stock prices by releasing misleading information.[66] Trying to avoid removal to federal court under preemption through the Securities Litigation Uniform Standards Act of 1998,[67] the plaintiff argued that he was neither a buyer nor a seller, but a holder of the security.[68] The Second Circuit, relying on *Blue Chip Stamp v. Manor Drug Stores*, found that "to the extent that the complaint in this action alleged that brokers were fraudulently induced, not to sell or purchase, but to retain or delay selling their securities, it fell outside SLUSA's pre-emptive scope."[69] The Supreme Court reversed, finding instead that:

> The holder class action that respondent tried to plead, and that the Second Circuit envisioned, is distinguishable from a typical Rule 10b-5 class action in only one respect: It is brought by holders instead of purchasers or sellers. For purposes of SLUSA pre-emption, that distinction is irrelevant; the identity of the plaintiffs does not determine whether the complaint alleges fraud "in connection with the purchase or sale" of securities. The misconduct of which respondent complains here--fraudulent manipulation of stock prices--unquestionably qualifies as fraud "in connection with the purchase or sale" of securities . . . .[70]

While SEC enforcement of Rule 10b-5 is not precluded against the credit rating agencies,[71] these developments reflect a trend to incorporate

64. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 85 (2006).

65. Moreover, the language in *Dabit* suggests that, as of 2006, the Court has come to view the *Blue Chip Stamps* rule as excessively restrictive. *Dabit*, 547 U.S. at 80. Additionally, it may be best to leave this gate-keeping function with the SEC. In theory, this would encourage responsible prosecution and a check on frivolous suits seeking to make money off of the natural unpredictability of the marketplace. *See also* Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (imposing limits on securities fraud class actions).

66. *Dabit*, 547 U.S. at 85.

67. *Id*. at 87 ("SLUSA does not actually pre-empt any state cause of action. It simply denies plaintiffs the right to use the class-action device to vindicate certain claims. The Act does not deny any individual plaintiff, or indeed any group of fewer than 50 plaintiffs, the right to enforce any state-law cause of action that may exist.").

68. *Id.* at 76.

69. *Id.* at 77.

70. *Id.* at 89.

71. SEC v. Zandford, 535 U.S. 813, 820-21 (2002) ("[I]n its role enforcing the Act, the SEC has consistently adopted a broad reading of the phrase 'in connection with the purchase or sale of any security'. . . . This interpretation of the ambiguous text of § 10(b) . . . is

the agencies within Rule 10b-5's "in connection with a sale of a security" even when the securities do not physically pass through the defendant's hands. Thus, if an agency wrongfully manipulates the price of a security, it would constitute fraud "in connection with the purchase or sale of [a] security."[72]

A. Scienter Requirement

Unlike the "actual malice" standard for fraud,[73] the standard for making such an untrue fact under Rule 10b-5 appears to be recklessness. In *Ernst & Ernst v. Hochfelder*, the Supreme Court defined the 10b-5 scienter requirement as "a mental state embracing intent to deceive, manipulate, or defraud,"[74] though it specifically left open the question as to whether recklessness could trigger liability:

> Neither the intended scope of § 10(b) nor the reasons for the changes in its operative language are revealed explicitly in the legislative history of the 1934 Act, which deals primarily with other aspects of the legislation. There is no indication, however, that § 10(b) was intended to proscribe conduct not involving scienter.[75]

The following year after *Ernst & Ernst v. Hochfelder*, the Court reiterated this particular ambiguity, stating that "[t]he only specific reference to § 10 in the Senate Report on the 1934 Act merely states that the section was 'aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function.'"[76] Furthermore, in 1983, the Supreme Court proclaimed "we have explicitly left open the question whether recklessness satisfies the scienter requirement."[77] This uncertainty endures today, though every federal court that has addressed this scienter element has found that Rule 10b-5 is satisfied by recklessness.[78] Thus, to hold such institutions liable, a reckless appraisal

entitled to deference if it is reasonable," (citing United States v. Mead Corp., 533 U.S. 218, 229-30 (2001))).

72. 17 C.F.R. § 240.10b-5. *See infra* Section B. Material Misrepresentation / Reliance Requirement (discussing the fraud aspect of such a charge).

73. *See supra* Section IV of this Comment (explaining the "actual malice" standard).

74. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94, n.12 (1976).

75. *Id.* at 202.

76. Santa Fe Indus. v. Green, 430 U.S. 462, 474 n.13 (1977) (citing S. REP. NO. 792, at 6 (1934)).

77. Herman & MacLean v. Huddleston, 459 U.S. 375, 379 n.4 (1983). *See also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007) (refusing to rule directly on the issue, but acknowledging that every Court of Appeals has accepted the reckless standard).

78. David Kaplan, Note, *The Scope of Bar Orders in Federal Securities Fraud Settlements*, 52 DUKE L.J. 211, 216 n.28 (2002) (citing Tower C. Snow et al., Defending

would be adequate. This is important because, as outlined above, there are sufficiently egregious examples of these agencies making reckless risk appraisals that are not currently being prosecuted. Moreover, recklessness is also a suitably lenient standard in that it would not extend culpability to any negligent misrepresentations that would naturally arise in a complex financial world.

It appears that the scienter requirement necessary to trigger Rule 10b-5 has been increased slightly in recent years. In light of allegations of false and misleading statements to the public by a scientific corporation, the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* again faced the question of what is required for a scienter.[79] The Court determined that in order to avoid "nuisance filings," SEC Rule 10b-5 had evolved a heightened pleading standard.[80] Specifically, the Private Securities Litigation Reform Act of 1995[81] imposed a "strong inference" standard for proving a defendant's state of mind.[82] In analyzing such a claim, one must look at "plausible nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff."[83] Specifically, "the reviewing court must ask: When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?"[84] Following this clarified standard, the Court remanded.[85]

While it now seems that the reckless requirement has been heightened in terms of particularity, this does not foreclose agency prosecution where there is ample evidence such as leaked memos, egregious conduct, and whistleblowers.[86] For instance, in *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*, the court held that allegations that compensation was contingent on the securities selling with the highest ratings was sufficient to

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Securities Class Actions, 2 A.L.I. PROC. 789, 834-41 (2000)); *see also* Robert N. Clemens Trust v. Morgan Stanley DW, Inc., 485 F.3d 840, 847 (6th Cir. 2007) (stating that "we have 'long premised liability on at least reckless behavior.'" (citing Helwig v. Vencor, Inc., 251 F.3d 540, 548 (6th Cir. 2001))); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 (6th Cir. 1979) (holding that "mere negligence is not enough for liability").

79. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314-17 (2007) (discussing how to weigh competing facts in order to come to a finding of scienter).

80. *See id.* at 320-21 (discussing the evolution of a heightened pleading standard).

81. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of Title 15 of the United States Code).

82. *See* Tellabs, 551 U.S. at 321 (explaining how the Private Securities Litigation Reform Act's heightened pleading standard imposes a difficult burden on plaintiffs).

83. *Id.* at 324.

84. *Id.* at 326.

85. *Id.* at 329.

86. PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 686 (6th Cir. 2004) (ruling that while it is unclear what exactly might satisfy this standard, "[s]pecific factual allegations that a defendant ignored red flags, or warning signs that would have revealed the accounting errors prior to their inclusion in public statements, may support a strong inference of scienter").

support an inference of motive.[87]

B. Material Misrepresentation / Reliance Requirement

In order to trigger Rule 10b-5, section (b) liability, a report must constitute an "untrue statement of material fact."[88] *Basic Inc. v. Levinson* reiterated that materiality is a fact-based inquiry that "depends on the significance the reasonable investor would place on the withheld or misrepresented information."[89] *TSC Industries v. Northway, Inc.* held that an "omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[90]

Following this standard, *Zewig v. Hearst Corporation* found a mere lack of objectivity (analogous to the conflict of interest problem present with the credit rating agencies, raised above) was sufficiently material to trigger liability under 10b-5.[91] Here, a financial columnist who habitually inflated stock prices after purchasing large amounts of stock was sued by two recipients of the overvalued stock for damages.[92] "Reasonable investors who read the column would have considered the motivations of a financial columnist . . . important in deciding whether to invest in the companies touted."[93] The Court of Appeals reversed and remanded, finding "the federal securities laws, in guarding the public from abuses, strictly circumscribe the opportunities of persons holding certain positions to profit from their positions."[94]

Specifically, Rule 10b-5 has enjoyed its most ready application to misstatements of material fact made by corporate boards. Notably, in 1968, the Second Circuit held in *SEC v. Texas Gulf Sulphur Co.* that such statements could be actionable as false or deceptive misrepresentations:

> More important, however, is the realization which we must again underscore at the risk of repetition, that the investing public is hurt by exposure to false or deceptive statements irrespective of

87. Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d at 179 (S.D.N.Y. 2009) ("[B]ecause the Rating Agencies were responsible for determining and issuing their ratings and devised the models that produced the allegedly unreasonably high ratings, the Rating Agencies had the opportunity to assign misleading ratings. Plaintiffs have thus sufficiently pled scienter as to the Rating Agencies.").

88. 17 C.F.R. § 240.10b-5(b).

89. Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988).

90. TSC Indus. v. Northway, Inc.. 426 U.S. 438, 449 (1976).

91. Zewig v. Hearst Corp., 594 F.2d 1261, 1266 (9th Cir. 1979) (holding that financial writer's undisclosed lack of objectivity was an omitted material fact).

92. *Id.* at 1265.

93. *Id.* at 1266.

94. *Id.* at 1271.

> the purpose underlying their issuance. It does not appear to be unfair to impose upon corporate management a duty to ascertain the truth of any statements the corporation releases to its shareholders or to the investing public at large. Accordingly, we hold that Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media . . . if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes.[95]

Specifically mentioning the financial media and the public at large, this holding strongly suggests that potential liability for credit rating agencies under Rule 10b-5 would fit squarely within the Rule's intended scope.

The concept of the reasonable investor has been refined by the Supreme Court in *Basic Inc. v. Levinson* to constitute "reliance and the fraud-on-the-market theory" in situations where a common law fraud has been established.[96] The Court has developed a presumption that investors rely on public information unless there is an affirmative showing that destroys any causal link.[97] In the face of allegations of corporate statements artificially lowering stock prices, the Court found that "[f]or purposes of accepting the presumption of reliance in this case, we need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices."[98] While this particular case was one of a "materially misleading statement by the corporation," not of an outside rating agency,[99] this should be a rather simple extension by analogy.

The recent case *DeMarco v. Lehman Brothers* has narrowed this avenue of attack, finding that "there is a qualitative difference between a

95. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 861-62 (2d Cir. 1968).

96. Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988). In *Wiggins v. Janus Capital Group, Inc.,* the plaintiffs alleged that Janus Capital Group had made misleading statements in their prospectus pertaining to their investment practices, causing their investors to lose money when contrary practices became known. In re Mut. Funds Inv. Litig., 566 F.3d 111, 114-15 (4th Cir. 2009), *cert. granted*, 79 U.S.L.W. 3325 (U.S. Nov. 23, 2010) (No. 09-525). Interpreting the *Basic* rule, the court wrote that to satisfy the fraud-on-the-market theory, "the defendant must make a misrepresentation that is public and is attributable to the defendant. This requirement is necessary to ensure that the misleading information 'is reflected in the market price of the security.'" *Id.* at 121 (citing Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 159 (2008)). The court held that the prospectus statements were sufficient to survive Rule 12(b)(6) dismissal under a fraud-on-the-market reliance theory. *Id.* at 127.

97. *Basic*, 485 U.S. at 248-49.

98. *Id.* at 246 n.24.

99. *Id.* at 226.

statement of fact emanating from an issuer and a statement of opinion emanating from a research analyst. A well-developed efficient market can reasonably be presumed to translate the former into an effect on price, whereas no such presumption attaches to the latter."[100] Specifically, the court required some additional quantum of evidence in order to establish the necessary causal connection in the case of an analyst's misstatement, as opposed to that of an issuer.[101] In *DeMarco*, a Lehman Brothers analyst encouraged investment in a particular common stock while privately maintaining contrary beliefs.[102] Although the plaintiffs did not plead with sufficient evidence to trigger a fraud on the market theory,[103] the court explicitly found that such allegations, if true, could generally be sufficient to merit fraud for a particularized Rule 10b-5 violation.[104]

Abu Dhabi Commercial Bank v. Morgan Stanley & Co. appears to gloss over this question of reliance.[105] Where a ratings agency argued that reliance was improper for "sophisticated investors," the court retorted that "the market at large, including sophisticated investors, have come to rely on the accuracy of credit ratings and the independence of rating agencies because of their NRSRO [Nationally Recognized Statistical Rating Organization] status and . . . the Rating Agencies' access to non-public information that even sophisticated investors cannot obtain."[106] Following this analysis, it appears quite possible to find reasonable reliance on these agencies, both legally and intuitively.

Finally, it is not necessary that there be an affirmative duty to disclose

100. DeMarco v. Lehman Bros., Inc., 222 F.R.D. 243, 246 (S.D.N.Y. 2004).

101. *See id.* at 247 ("[A] statement of opinion emanating from a research analyst is far more subjective and far less certain, and often appears in tandem with conflicting opinions from other analysts as well as new statements from the issuer. As a result, no automatic impact on the price of a security can be presumed and instead must be proven and measured before the statement can be said to have 'defrauded the market' in any material way that is not simply speculative.").

102. *Id.* at 245.

103. *Id.* at 247 (arguing that in order "to qualify for class certification in a case where, as here, such certification is dependent on invocation of the fraud-on-the-market doctrine, the plaintiff must adduce admissible evidence that facially meets the aforementioned standard, *i.e.*, that makes a *prima facie* showing that the analyst's statements alleged to be false or fraudulent materially and measurably impacted the market price of the security to which the statements relate").

104. *Id.* at 245.

105. Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155 (S.D.N.Y. 2009).

106. *Id.* at 181. "In assessing the reasonableness of a plaintiff's alleged reliance, we consider the entire context of the transaction, including factors such as its complexity and magnitude, the sophistication of the parties, and the content of any agreements between them." *Id.* at 180-81 (quoting Crigger v. Fahnestock & Co., 443 F.3d 230, 235 (2d Cir. 2006)).

information or opinions for an activity to be actionable under Rule 10b-5.[107] Specifically, a "lack of an independent duty is not . . . a defense to Rule 10b-5 liability because upon choosing to speak, one must speak truthfully about material issues."[108] Thus, even if the ratings agencies were acting as a mere public service, their promulgation of any rating—having met all the other Rule 10b-5 elements—would still actionable outside of any fiduciary relationship.

VI. THERE IS PRECEDENT FOR SUCH LIABILITY FOR STATEMENTS OF OPINION IN THE SECURITIES CONTEXT.

In the case of *Franklin Savings Bank v. Levy*, the Second Circuit found that ratings agencies could be potentially liable under Section 10b.[109] There, commercial paper dealer Goldman Sachs, the sole dealer in commercial notes for Penn Central Transportation Agency (Penn Central), bestowed upon Penn Central the highest rating of "prime" and sold shares to Franklin Savings Bank.[110] (Like many requirements of law mentioned earlier, banks in the state of New York were only allowed to purchase securities which had been given a "highest rating" by an independent agency.)[111] At the time of the purchase, Penn Central had already experienced heavy losses, and Goldman had attempted to force Penn Central to buy back some of its own holdings.[112] Moreover, a separate investment bank, holding fifteen percent of Penn Central's commercial paper, had concurrently removed Penn Central from its list of approved investments.[113] Penn Central went bankrupt before the maturity date, and Franklin Savings Bank was never paid.[114]

Franklin Savings Bank alleged that it had been cheated, but Goldman argued that their rating constituted "merely an opinion only actionable if that opinion was dishonestly or recklessly held."[115] Yet, the Second Circuit found that in certain circumstances a rating could be regarded as a fact:

> We have been loath . . . to permit a broker-dealer to escape liability under § 10(b) of the 1934 Act by recourse to the fact-opinion dichotomy. We have held that where a broker-dealer

107. *See* Caiola v. Citibank, 295 F.3d 312 (2d Cir. 2002) (concerning a bank that misrepresented the nature of the investments it was making on behalf of a substantial client).

108. *Id.* at 331.

109. Franklin Sav. Bank v. Levy, 551 F.2d 521 (2d Cir. 1977).

110. *Id.* at 522-23.

111. *Id.* *See supra* Section III of this Comment (outlining the general existence of ratings requirements for certain institutional investors).

112. *Id.* at 523.

113. *Id.*

114. *Id.*

115. *Id.* at 526 (Responding to §12(2) under the 1933 Act).

> makes a representation as to the quality of the security he sells, he impliedly represents that he has an adequate basis in fact for the opinion he renders.[116]

In finding the potential for liability under Section 12(2) of the 1933 Act,[117] the court went as far as to find that representations can be misleading in fact even if they are honestly believed in practice:

> If Goldman, Sachs failed to exercise reasonable professional care in assembling and evaluating the financial data, particularly in view of the worsening condition of Penn Central, then its representation that the paper was credit worthy and high quality was untrue in fact and misleading no matter how honestly but mistakenly held.[118]

Under this view, the court devised a system of burden-shifting. "[I]t in fact makes the dealer responsible . . . if it is unable to shoulder the burden of establishing that it was not reasonable for it to have determined . . . the quality of the paper it was purveying was less than that represented."[119] Unfortunately, this analysis did not carry over to the Section 10b-5 analysis, which got stuck on the strong scienter requirement that had been recently established by *Hochfelder*.[120] However, as established above, such a burden may no longer be accurate, and is not required for prosecution by the SEC.[121]

In another case stemming from the Penn Central debacle, *Mallinckrodt Chemical Works v. Goldman, Sachs & Co.*, a suit was initiated against a credit rating agency that provided credit appraisals exclusively to subscribers.[122] Specifically, the rating agency had rated the

116. *Id.* at 527.

117. Section 12(2) of the 1933 Act provides for similar liability as Rule 10b-5 for misleading statements ("includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements"), but could not be applied to ratings agencies as the Act is limited to "issuers" of securities, meaning "every person who issues or proposes to issue any security." 15 U.S.C. §§ 77l(a)(2), 77b(a)(4).

118. *Franklin Sav.*, 551 F.2d at 527.

119. *Id.*

120. *Id.* at 529 (finding that the lower court's opinion "never found that Goldman, Sachs possessed an intent to deceive, manipulate or defraud").

121. *See supra* Section IV of this Comment (elaborating on the scienter requirement for Rule 10b-5).

122. Mallinckrodt Chem. Works v. Goldman, Sachs & Co., 420 F. Supp. 231, 235-36 (S.D.N.Y. 1976). Although the court may have been more willing to consider Rule 10b-5 liability in the presence of such privity, *see supra* Section IV of this Comment, the court also found that "one would be naive to believe that [the agency] was completely unaware that purchasers on occasion did inquire from the seller as to the rating." *Mallinckrodt*, 420 F. Supp. at 236. "The NCO rating is not like a bond rating that is published and quoted for the world to see, nor is the rating available to the general public. However, when specifically asked by customers what the rating was, some . . . salesmen would tell them." *Id.* Moreover, the plaintiff in this case was not himself a subscriber. *Id.* at 234. While the

Penn Central Transportation Company's commercial paper as "prime"—the only grade of security the plaintiff would agree to purchase.[123] The court, assuming that the rating "was a statement of fact, rather than an opinion" found that the "prime" rating was acceptable, and that "if there was a misstatement of fact, it was an unwitting one."[124] While seemingly willing to go forward on the Rule 10b-5 claim against the ratings agency, this court also got stuck on the scienter requirement for the question of ultimate liability.

Similarly, *Virginia Bankshares v. Sandberg* is another example of potential statements of opinion leading to liability.[125] There, the corporate directors solicited proxies seeking approval by the minority shareholders of a "freeze out" merger where they would lose their interests for cash reimbursement.[126] In doing so, the directors "urged the proposal's adoption and stated they had approved the plan because of its opportunity for the minority shareholders to achieve a 'high' value, which they elsewhere described as a 'fair' price, for their stock."[127] Petitioner Sandberg argued liability under Rule 14(a)[128] that the directors did not truly believe that the price was high or fair, but instead such statements were only made to protect their board positions.[129]

The court affirmed the jury decision upholding Sandberg's appraisal.[130] They further agreed that "a statement of belief by corporate directors about a recommended course of action, or an explanation of their reasons for recommending it . . . " could be sufficiently material.[131] Moreover, the conclusory nature of such statements was not dispositive:

> Provable facts either furnish good reasons to make a conclusory commercial judgment, or they count against it, and expressions of such judgments can be uttered with knowledge of truth or falsity just like more definite statements, and defended or attacked

court went on to find no actual reliance by the plaintiff on the credit rating, this was not for lack of a subscription, but simply a finding of fact that the plaintiff had relied instead on his own judgment. *Id.* at 243.

123. *Id.* at 233.

124. *Id.* at 241-42. "There is no evidence that NCO's judgments on PCTC were not made in good faith or that its judgments or reports were false." *Id.* at 243.

125. Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991).

126. *Id.* at 1087-88.

127. *Id.* at 1088.

128. Rule 14(a) of the Securities Exchange Act of 1934 pertains to the solicitation of proxies. 17 C.F.R. § 240.14a.

129. *Virginia Bankshares*, 501 U.S. at 1088–89.

130. *Id.* at 1090.

131. *Id.* at 1090–91. *See also* Mayer v. Mylod, 988 F.2d 635, 639 (6th Cir. 1993) ("Material statements which contain the speaker's opinion are actionable under Section 10(b) of the Securities Exchange Act if the speaker does not believe the opinion and the opinion is not factually well-grounded.").

> through the orthodox evidentiary process that either substantiates their underlying justifications or tends to disprove their existence . . . . However conclusory the directors' statement may have been, then, it was open to attack by garden-variety evidence, subject neither to a plaintiff's control nor ready manufacture, and there was no undue risk of open-ended liability or uncontrollable litigation in allowing respondents the opportunity for recovery on the allegation that it was misleading to call $42 'high.'[132]

Of course, proof would be necessary in order to establish the existence of statements based on disbelief.[133]

Unfortunately for Sandberg, the court's reasoning ultimately did not culminate in his favor--the court concluded that there was no federal remedy for the minority shareholders, who were alone insufficient to overturn the merger, regardless of the culpability of the representations.[134] Yet, taken together, these cases analogize well to potential cases the credit rating context and the enforceability of Rule 10b-5 therein.

VII. ARGUMENTS AGAINST

While the market for complicated investments is naturally volatile, such assumption of risk should not work to foreclose any and all liability against the credit raters. Risk-taking is an inherent part of securities trading, but it is an entirely different risk than the threat of deceit based on reckless and material misrepresentations. Investors should be concerned about the future of the market and their particular portfolios, but they should not be burdened with the additional concern that the ratings agencies they are dependent upon are engaged in fraud, especially in instances where investors are forced by law to rely on those agencies. Credit raters should not be allowed to represent that they offer a profitable product to help hedge market risk while simultaneously hiding behind that same risk to avoid any and all accountability.

Concerns that the threat of liability for these agencies will cause a dearth of ratings are similarly unfounded. Since the standard for Rule 10b-5 is only recklessness, it will merely encourage appropriate caution in calculating ratings and eliminate instances of purposeful misconduct—an optimal balance. To any extent that this may lead to a "limited chilling effect" it might not be a terrible outcome for an industry predisposed to heedlessness (especially in the face of market bubbles that skew and dilute perceptions of risk). Clearly, setting a *de facto* bar to any enforcement only

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132. *Virginia Bankshares*, 501 U.S. at 1093–95.

133. *Id.* at 1096 (reinforcing the concept of a higher burden of proof for the moving party in commercial contexts).

134. *Id.* at 1106 (denying petitioner's conclusory argument).

encourages ratings to develop without sufficient caution, leading to risky and inaccurate appraisals that will eventually culminate in catastrophe. In comparison, a slight reduction in excessively optimistic ratings does not seem so troublesome. As long as there is a market for investments, there will always be a market for honest assessment of those investments. Thus, the potential for reasonable liability will encourage the ultimate goal of fostering diligent and responsible evaluation of such securities.

Proving recklessness presents a complex task, and agencies will inevitably get away with unfounded appraisals under such a standard. Yet, as this comment makes clear, there are sufficient examples in this crisis of clear reckless conduct, and discovery in a well-pleaded case would get at the appropriate evidence, should it exist. Liability mechanisms will also serve to incentivize investors and regulators to bring potential problems to the rating agencies' attention, knowing that the agencies would not be free to ignore the problem. Finally, setting the culpability standard at "reckless" encourages an optimal level of responsibility against a reasonable amount of protection for the agencies, avoiding an excessive chilling effect and benefiting the market as a whole.

The major hurdle to 10b-5 liability is that courts have traditionally deferred to the firms' supposed First Amendment protections.[135] Additionally, the courts have expressed similar concern that these agencies do not meet the requirement of "in connection with the sale of a security." But as I have shown, these hurdles have been overcome singularly in a variety of contexts, meaning they are not insurmountable and are no longer appropriate barriers to the consistent application of Rule 10b-5 in the rating agency context.

VIII. CONCLUSION

Public policy demands a reliable liability mechanism to deter the ratings agencies from making self-interested, but ultimately detrimental, misstatements. Thus, there is every reason to utilize SEC Rule 10b-5 on its own terms to police such misrepresentations on the part of these agencies. It is a natural fit. The securities markets have undergone many changes since Rule 10b-5 was promulgated in 1942, and the increasing complexity of these markets, combined with the corresponding growth of the ratings agencies, certainly merit the application of Rule 10b-5—especially in light of recent economic lessons.

Such application of the Rule would not mean unlimited liability for

135. *See* Deryn Darcy, Survey, *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. 605, 632 (identifying court protection of ratings under the First Amendment as a hurdle when attempting to hold agencies liable).

credit rating agencies, but a mere burden shifting under a recklessness standard. From a policy perspective, this offers a device not only for future deterrence, but also for accountability by compelling such agencies to prove that their ratings were not unfounded, as many of them have tragically been. Investors rely on these ratings, in the exact same way they rely on corporate disclosure documents, and they should be held to a corresponding standard, to the level Rule 10b-5 demands.