Legal Liability of U.S. Credit Rating Agencies under Section 11 of the Securities Act: the Long and Winding Road toward accountability

by

Sisi Zhang

A thesis submitted in conformity with the requirements for the degree of Master of Laws
Graduate Department of the Faculty of Law
University of Toronto

© Copyright by Sisi Zhang (2010)
Legal liability of U.S. Credit Rating Agencies under Section 11 of the Securities Act: the Long and Winding Road toward Accountability

Sisi Zhang

Master of Laws
Faculty of law
University of Toronto
2010

Abstract

This paper argues that credit ratings have contributed to the current financial crisis. In United States, the previous “reputational model” as well as the current proposals aimed at reducing reliance on rating agencies, enhancing competition and increasing transparency is not sufficient to improve the integrity of rating agencies. This paper suggests that imposing stricter liability on rating agencies is necessary. The proposal to eliminate the exemption of NRSROs under Section 11 of the Securities Act is necessary but not sufficient for holding rating agencies accountable. The first amendment defense always shields rating agencies from legal liability, while the absence of a common standard make it hard to impose liability for negligent ratings. Finally, this paper suggests that the courts should not award the rating agencies First Amendment protection and consider the distinguished characteristics of rating agencies, when examining the professional liability of the agencies.
# Table of Contents

Introduction ................................................................................................................................. 1

I Need for rating agency accountability ......................................................................................... 2

1.1 The significance of rating agencies ......................................................................................... 2

1.1.1 The demand for credit ratings ............................................................................................ 2

1.1.2 Development of rating agencies and the use of ratings in financial regulations ............... 4

1.1.3 The culpability of rating agencies in the Subprime Crisis ................................................... 5

1.2 Perceived problems of rating market ....................................................................................... 6

1.2.1 Conflict of interest .............................................................................................................. 6

1.2.2 Limited competition ........................................................................................................... 7

1.2.3 Over-reliance on credit rating: rating-dependant regulation ............................................. 8

1.2.4 Lack of “transparency” ....................................................................................................... 8

1.3 Alternative solutions for irresponsible ratings are not sufficient ........................................ 9

1.3.1 The reputational constraints are not sufficient ................................................................. 9

1.3.2 Fostering competition is not a good option ....................................................................... 10

1.3.3 Reducing reliance on ratings is not a solution .................................................................. 11

1.3.4 Why disclosure requirement are insufficient for deterring CRAs from compromising ratings .............................................................................................................................................. 14

II Absence of Accountability: a study of previous cases ................................................................. 19

III Justifications for imposing expert liability under section 11 on rating agencies ....................... 22

3.1 Original reasons for exemption are not sufficient ................................................................. 22

3.2 Imposing liability would improve investor protection and ratings quality ............................ 24

3.3 Expert liability is consistent with the nature of credit ratings ............................................. 26

3.3.1 Scope of section 7 and section 11 ................................................................................... 27

3.3.2 Common law opinion ....................................................................................................... 28

3.3.3 Comparisons with other experts that are subject to liability under section 11 ................. 28

IV Regulatory obstacles for alleging the claims under section 11 .................................................. 30

4.1 First amendment protection ................................................................................................... 30

4.1.1 First Amendment protection defense .................................................................................. 31

4.1.2 Denial of press privilege in credit rating agency cases .................................................... 32
4.1.3 Characteristics of the credit rating agencies distinguished them traditional media 35

4.2 Absence of a common standard .................................................................................... 36

Conclusion ............................................................................................................................ 39
Introduction

Credit ratings agencies (hereinafter referred to as “CRA”) greatly underestimated the risks associated with subprime securities. Overvalued appraisal of risky securities by credit rating agencies encouraged a flow of global investor funds into these securities, funding the housing bubble in the United States. The agencies’ failure to evaluate accurately mortgage-backed securities contributed to the collapse of the housing market, thereby triggering a global financial crisis.\(^1\) Despite the role of rating agencies, it is very hard for investors to sue them for giving inflated evaluations to subprime residential mortgage-backed securities. In short, credit rating agencies abused the favorable legal and regulatory environments of rating industry.

This paper covers the need and justifications for imposing stricter liability on rating agencies, as well as the current obstacles for alleging claims against rating agencies. Part I begins with an illustration of the need for rating agency accountability. In this part, I analyze the significance of rating agencies, the perceived problems of the rating market, and alternative solutions for irresponsible ratings. Part II examines the United States federal cases against the three major rating agencies (Moody’s, S&P, Fitch). Part III analyzes the justifications for imposing liability. Part IV introduces the regulatory obstacles for alleging the claims. Finally, the last part of the thesis concludes with a critique of the legal liability of credit rating agency and relative suggestions.

---

I Need for Rating Agency Accountability

1.1 The Significance of Rating Agencies

Credit rating agencies "provide [their] opinion[s] on the creditworthiness of an entity and the financial obligations (such as, bonds, preferred stock, and commercial paper) issued by an entity." Credit rating agencies are considered one of the outside "gatekeepers" who protect outside investors by evaluating issuers.

1.1.1 The demand for credit ratings

While the financial market grow dramatically in the recent decades, the roles that credit rating agencies play in the investment decisions of financial market participants become highly important.

First, credit ratings affect issuers’ access to and cost of capital. They influence the structure of financial instruments. Issuers seek credit ratings to help them sell the securities. It is quite obvious that higher ratings would improve the marketability of the security,

---


in part because many institutional investors can only purchase investment-grade offerings.\textsuperscript{4} In addition, obtaining a favorable rating makes it possible for the issuer to lower the interest rate offered on their securities.\textsuperscript{5}

Second, credit ratings influence the decisions of investors.\textsuperscript{6} Potential buyers (mutual funds, pension funds, and insurance companies are substantial users of credit ratings) use credit ratings to comply with internal by-law restrictions or investment policies that require certain minimum credit rating, and to ensure compliance with various regulatory requirements.\textsuperscript{7}

Third, credit ratings are also crucial for the sell-side. Sellers use credit ratings in addition to their own credit analysis for risk management and trading purposes. For instance, broker dealers “assist underwriting clients in selecting appropriate credit rating agencies for their offerings, and help guide their clients through the ratings process”\textsuperscript{8} Credit ratings even play a key role in private contracts. If a rating declines, it can “trigger” demands by counterparties for additional collateral or for repayment, which could lead to an escalating liquidity crisis for issuers subject to ratings triggers.\textsuperscript{9}

In sum, credit rating agencies play an important role in the security markets, as shown in the ongoing financial crisis.

\textsuperscript{4} See the following section concerning the regulatory reliance on the credit ratings. For instance, Rule 2a-7 under the Investment Company Act of 1940, which limits money-market funds to investments in “Eligible Securities,” a category that includes only securities that have high NRSRO ratings


\textsuperscript{6} Ibid


\textsuperscript{8} Ibid

\textsuperscript{9} Rom, supra note 5
1.1.2 Development of rating agencies and the use of ratings in financial regulations

Credit rating agencies originated in the United States during the 1850s to provide information on the railroad industry’s financial status.\textsuperscript{10}

Up to the 1930s, before the separation of the banking and securities businesses in the United States with passage of the Glass-Steagall Act of 1933, the rating agencies were small and marginally profitable.\textsuperscript{11}

Rating agencies entered a period of rapid growth following the crash of 1929. In 1930, the Federal Reserve began using bond ratings in their examination of the portfolios of member banks. For instance, amendments to the Federal Banking Act in 1935 provided that national banks could purchase only securities that were rated BBB or higher, as prescribed in the definition of “investment securities”, by the Comptroller of the Currency.\textsuperscript{12} In the meanwhile, during the 1930s, demand for credit ratings increased, since investors became more concerned about bond default and credit risk.\textsuperscript{13}

From 1940 to 1970, regulatory dependence on credit ratings did not change much, while there was little growth in credit rating industry.\textsuperscript{14}

The increase of regulatory dependence on credit ratings began in 1973 when, following the credit crises of the early 1970s, the SEC adopted Rule 15c3-1, the first securities rule

\textsuperscript{12} Paragraph 7 of Section 5136 of the revised statues of the U.S., as amended by Section 308 of the Banking Act of 1935
\textsuperscript{13} Sinclair, Supra note 6, at 24
\textsuperscript{14} Partnoy, Supra note 10
formally incorporating credit ratings, and thereby approved the use of certain credit rating agencies as Nationally Recognized Statistical Rating Organization (hereinafter refer as NRSRO).\textsuperscript{15} Rule 15c3-1 set forth certain broker-dealer “haircut” requirements, and required a different haircut for securities based on credit ratings assigned by NRSROs.\textsuperscript{16} Since 1973, there have been credit-rating dependent rules and regulations promulgated under the \textit{Securities Act of 1933}, the \textit{Securities Exchange Act of 1934}, the \textit{Investment Company Act of 1940}, and various banking, insurance, pension, and real estate regulations. With this increase in the importance of ratings, the third period of rating development began. The credit rating industry began to become more influential and more profitable since mid-1970s.\textsuperscript{17} The rating agencies were extended to the commercial paper market and to bank deposits. Also in 1970s, the major rating agencies began the practice of charging issuers as well as investors for rating services.\textsuperscript{18}

In sum, the evidence demonstrates that the regulatory dependence on credit ratings began in 1930s and increased rapidly in the 1970s, these regulatory developments in turn contributed to the increased profitability of the credit rating industry.

1.1.3 The Culpability of Rating Agencies in the Subprime Crisis

Considerable attentions have been paid to the credit rating agencies since the beginning of the ongoing subprime crisis. The so-called “subprime crisis” began in summer 2007. Most subprime and Alt-A mortgages were held in residential mortgage-backed securities (RMBS),

\textsuperscript{15} Ibid
\textsuperscript{16} See \textit{Net Capital Requirements for Brokers or Dealers}, 17 C.F.R. 240.15c3-1
\textsuperscript{17} Partnoy, Supra note 10
most of which were rated investment grade by one or more rating agencies. Furthermore, collateralized debt obligations (CDOs), many of which held RMBS, were also rated by the Rating Agencies. According to the Financial Crisis Inquiry Commission’s study on the volume of ratings by Moody’s, Moody’s rated $4.7 trillion in RMBS and $736 billion in CDOs between 2000 and 2007. Among these bonds, 90% RMBS (by dollar amount) and 84% CDOs (by dollar amount) were rated AAA. However, the sharp rise in mortgage defaults that began in 2006 ultimately led to the mass downgrading of RMBS and CDOs, many of which suffered principal impairments. Their failure to reflect the risks of the product is regarded as one of the elements that triggered the crisis.

1.2 Perceived problems of rating market

1.2.1 Conflict of interest

Rating agencies face a number of potential conflicts of interest, the most obvious one arises from the fact that most of the agencies are paid by the issuers subject to their ratings. Today, credit rating agencies receive approximately 90% to 95% of their annual revenues from issuer fees. Of the ten credit rating agencies registered with the SEC as NRSROs, seven operate predominantly under the issuer-pay model; the remaining three operate under the

---


21 Ibid

22 Ibid

subscriber-pay models. The adoption of the issuer pays model created the risk that a credit rating agency will compromise the integrity of its ratings to appease the issuer, its paying customer, by issuing an undeservedly high rating or by failing to downgrade a security when changes warrant it.

1.2.2 Limited competition

According to the BIS (Bank for International Settlements) report in 2000, there are a total of 28 rating firms primarily from the G10 countries. The report also estimates that the number of credit rating firms in existence worldwide has reached 130-150. With respect to NRSROs in United States, ten credit rating agencies have been granted NRSRO registration. However, three major credit rating agencies, Moody's, Standard & Poor's, and Fitch, dominate the ratings industry. According to Annual Report on Nationally Recognized Statistical Rating Organizations, the total ratings reported by the ten NRSROs for the year 2008 in United States are 3,123,748, while the three major agencies are responsible for having issued approximately 97% of all outstanding ratings across all categories reported.

---

27 supra note 24
1.2.3 Over-reliance on credit rating: Rating-dependant regulation

As mentioned before, agency ratings are incorporated into financial regulation. These rating dependant regulations create a source of demand for ratings and have been regarded as one of the reasons that motivate the development of credit rating. An issuer may demand a rating because investors need the rating to fulfill regulatory or other requirements, even if neither party believes that the rating is a high-quality assessment of creditworthiness. The regulatory reliance on ratings explains how rating agencies can do well even if the quality of their analysis is poor.

1.2.4 Lack of “transparency”

Proposals have been made to permit the voluntary disclosure of security ratings assigned by NRSROs to classes of debt securities, convertible debt securities and preferred stock in registrations statements filed since 1981. In 1994, the Commission published a proposing release that would have required mandatory disclosure of a credit rating given by an NRSRO. However, up to now, the mandated disclosure requirement has not been adopted yet. Currently, it is not required for the registrants to disclose in registration statements and periodic reports the credit ratings assigned to classes of debt securities, convertible debt

---

Without a mandated disclosure requirement, nor an instant grading system to evaluate the self-registration, the registrants have no strong incentive to disclose applicable ratings, thereby the lack of “transparency” problem has always been an issue. Regulators have put many efforts to promote rating-agency transparency, especially since the crisis began.

1.3 Alternative solutions for irresponsible ratings are not sufficient

1.3.1 The Reputational Constraints are not sufficient

As we trace back to the regulatory history of rating agencies, it is not hard to find that before the crisis, the credit rating industry mostly relied on self-regulation. In 2006, however, the US Congress passed the Credit Rating Agency Reform Act of 2006, ending a century of industry self-regulation and providing the SEC authority to supervise the credit rating industry for the first time. The Act’s overriding purpose was to promote competition in the rating industry by establishing a transparent and rational registration system for rating

---

30 Regulation S-K, 17 C.F.R. 229.10. Item 10(c) of Regulation S-K “The Commission permits registrants to disclose, on a voluntary basis, ratings assigned by rating organizations to classes of debt securities, convertible debt securities and preferred stock in registration statements and periodic reports.

agencies seeking NRSRO status. It was also designed to enhance industry transparency, address conflicts of interest, and prohibit abusive practices.32

Before 2006, in the long history of self-regulation, the rating industry has been working under a “reputational model”33. It was believed that the fear of loss of reputation provides the right incentives for the rating agencies to overcome the temptations originating from the conflict of interest problem and perform responsibly. However, the recent crisis offers strong evidence showing that the reputation mechanism has failed to lead to optimum rating quality. In addition, John Patrick Hunt pointed out that the rating agency reputation is not likely to guarantee high-quality ratings on novel financial products, such as the structured financial product, principally because the credit rating agencies have no reputation to lose in this type of rating.34

1.3.2 Fostering competition is not a good option

It is true that if there are more competitors, then the probability that at least one of the rating agencies will produce high-quality ratings is higher. However, the increasing of competition cannot address the conflict of interest problem. Competition does not affect the incentives of a low-quality agency to issue ratings, since the low-quality agency gets some revenue if it issues low-quality ratings but will earn nothing if it refrains from doing so. In addition, since lower price level would be expected from increased competition, it would be more likely for the issuer to shop more ratings from more than one rating agencies to get higher ratings. It is feared that a “Race to the bottom” would be triggered by the expansion of rating agencies.

32 See Credit rating agency reform act of 2006, 15 U.S.C.A. 78o-7, the act is “To improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.”
33 Hunt, supra note 28
34 Hunt, supra note 28
Competition increases the short-terms gains of cheating, and hence makes the poor performance harder to be deterred by the prospect of loss of reputation.  

More importantly, according to the finding of Bo Becker and Todd Milbourn (2009), using the rise of a third ratings agency to examine the level of competition and the efficiency of credit rating, competition leads to lower quality in the ratings market: “the incumbent agencies produce more issuer-friendly and less informative ratings when competition is stronger.” In short, increased competition appears to have reduced the accuracy of credit ratings.

1.3.3 Reducing reliance is not a solution

1.3.3.1 The Scope of Rating-Dependent Regulation

According to the SEC report, there are at least forty-four of its rules and forms currently incorporating agency ratings; the staff is recommending changes to 38 of them. It recently highlighted three of the provisions in particular: (1) Rule 3a-7 under the Investment Company Act, which exempts structured-finance vehicles from the Act as long as the securities receives one of the four highest ratings from an NRSRO. The SEC recently proposed to change this

rule to remove reference to ratings and to exempt structured-finance vehicles that sell only to qualified institutional buyers and accredited investors (as opposed to retail investors). \(^{39}\) (2) Rule 15c3-1 under the *Securities Exchange Act of 1934*, which requires that broker-dealers maintain net capital equal to a fraction of liabilities and provides that debt securities, commercial paper, and other instruments count for more toward the net capital requirement if they receive high ratings from NRSROs; \(^{40}\) and (3) Rule 2a-7 under the *Investment Company Act of 1940*, which limits money-market funds to investments in “Eligible Securities,” a category that includes only securities that have high NRSRO ratings, or “that [are] of comparable quality” to a security meeting the NRSRO-based test. \(^{41}\) The SEC has proposed amendments that would remove the reference to credit ratings in the rules and would allow money market fund managers, based on their own judgments, to invest in any assets that meet quality and liquidity requirements. \(^{42}\)

Agency ratings have been incorporated into the U.S. bank regulatory system since 1931. \(^{43}\)

U.S. regulators currently intend to permit banks to choose either to create an internal rating

---


\(^{40}\) *Net capital requirements for brokers or dealers* 240.15c3-1(a)(1). Specifically, the rule provides that a security's contribution to the broker-dealer's net capital is its market value less a “haircut.” The haircuts for commercial paper, banker's acceptances, certificates of deposit, nonconvertible debt securities, and cumulative nonpreferred stock all are smaller if they are rated by an NRSRO in one of the three or four top rating categories. 17 C.F.R. 240.15c3-1(c)(2).

\(^{41}\) *Money market funds, rules and regulation under investment company act of 1940* 17 C.F.R., 270.2a-7(a)(10), (a)(21), (c)(3)(i).

\(^{42}\) Supra note 40

\(^{43}\) In 1931, the Office of the Comptroller of the Currency determined that national banks were required to carry bonds that did not receive an investment-grade rating at a discount to cost, while bonds with investment-grade ratings could be carried at cost. These rules were further elaborated through the 1930s. The FDIC “prevents insured banks from investing in speculative-grade securities or enforces risk-based capital requirements that use credit ratings to assess risk-weights.”
regime (subject to a number of constraints) or to rely on agency ratings to measure asset risk.

The Employee Retirement Income Security Act (ERISA) also incorporates ratings. The ERISA fiduciaries are constrained to invest in only ERISA-eligible securities, securities that receive “investment-grade” ratings from the NRSROs.45

1.3.3.2 Reform of Rating-Dependent Regulation

In the wake of the crisis, the SEC has begun to reduce, but not eliminate, its reliance on ratings. As of August, 2010, the status of that proposal is still unclear. Although the SEC had adopted some of its summer 2008 proposals and re-proposed others in modified form, it had not taken any action on the proposal to reduce its reliance on agency ratings.

1.3.3.3 Why Reducing reliance on ratings is not a solution

First of all, it’s impossible to reduce all the reliance without finding an adequate replacement. For example, proposals to amend Rules 2a-7 and 3a-7 under the Investment Company Act is to delete their requirement for NRSRO investment grade ratings and to require the board of money market funds to make a determination that each portfolio investment "presents a minimal credit risk"; each board would be expected to make the determination by relying on outside sources, "including NRSRO ratings that they conclude are credible."46 The problem is that the boards of money market funds (or other institutional investors) are not in a position

45 Supra note 40
to conduct a security-by-security evaluation of credit risk and need to rely on professional advisors.\(^{47}\)

More fundamentally, efforts to improve rating quality by reducing rating-dependent regulation share the assumption that a well-functioning reputation can in principle produce high quality ratings, an assumption which has proved highly questionable in light of the ongoing crisis.\(^ {48}\)

1.3.4 Disclosure requirement is insufficient for deterring CRAs from compromising ratings

1.3.4.1 Proposals

First of all, proposals have been made concerning registration statement disclosures regarding credit ratings. The SEC has proposed to impose mandatory disclosure requirements on issuers in registered securities offerings, including those by closed-end funds, when credit ratings are “used” in connection with the sale of those securities. In brief, the amendments would require such issuers to describe in their registration statements (a) general information about the scope and limitations of the rating; (b) potential conflicts of interest; (c) and preliminary and other final ratings.\(^ {49}\)

Moreover, there are proposals with respect to NRSRO oversight. Firstly, an amendment has been proposed to require disclosure of ratings histories of all ratings. The amendments to

---


\(^{48}\) Hunt, supra note 28

Exchange Act Rule 17g-2(d), which contain recordkeeping and disclosure requirements applicable to NRSROs, require each NRSRO to publicly disclose on its website complete ratings action histories for 10% of outstanding issuer-paid ratings.\textsuperscript{50} Secondly, disclosure requirement was proposed regarding the Structured-Finance ratings paid for by arrangers. Exchange Act Rule 17g-5 describes certain conflicts of interest that must be disclosed and managed as well as other conflicts of interest that are prohibited entirely.\textsuperscript{51} The proposed amendments and rules would require an NRSRO: (i) to furnish a new annual report describing the steps taken by the firm’s designated compliance officer during the fiscal year with respect to compliance reviews, identifications of material compliance matters, remediation measures taken to address those matters, and identification of the persons within the NRSRO advised of the results of the reviews; (proposed amendment to rule 17g-3)(ii) to disclose additional information about sources of revenues on Form NRSRO; and (iii) to make publicly available a consolidated report containing information about revenues of the NRSRO attributable to persons paying the NRSRO for the issuance or maintenance of a credit rating.\textsuperscript{52}

In sum, the proposals regarding the disclosure of rating agencies cover many aspects of the credit rating business, including the mandatory disclosure requirement in the registered offering. More importantly, the proposed amendments require disclosures that would inform investors about potential conflicts of interest that could affect the credit rating.

1.3.4.2 Why disclosure requirements are insufficient for deterring CRAs from compromising ratings

Considering the disappointing performance of the rating agencies in recent years which contributed to the breakout of the subprime crisis, the current voluntary disclosure requirement is not effective in preventing CRAs from irresponsible ratings.

In light of the above mentioned proposals, a lot of efforts have been put to improve the transparency of ratings. Those disclosure requirements have covered many aspects, including those dealing with the conflict of interest problem. Such disclosure requirements can to some extent deter the rating agencies from giving irresponsible ratings. For instance, disclosure is required to inform investors about potential conflicts of interest that could affect the credit rating. It is proposed that if a registrant has obtained a credit rating and is required to disclose that credit rating, then all preliminary ratings of the same class of securities as the final rating that are obtained from credit rating agencies must also be disclosed. 53 If these disclosure requirements are adopted, important information will be provided to investors about potential rating shopping. Since all the preliminary ratings would become public, the issuers would have less incentive to seek a different credit rating from another credit rating agency when it believes that the preliminary rating is too low, thereby deterring the issuers from shopping for favorable opinions from different rating agencies. Thus, it is reasonable to believe that such disclosure requirement would help improve the integrity in the credit rating process. The disclosure-based regulatory regime is expected to increase accountability and incentivize credit rating agencies to modify undesirable behavior.

53 Credit ratings disclosure, supra note 49
However, given the complexity in the credit rating process, even if the registration material, the performance and the methodology of the credit rating are made public, it will still be very difficult for the investors to fully understand and assess the quality of ratings. With respect to the complex structured transactions, one scholar has noted that “most investors do not have the ability to evaluate structured transactions.”

Investors may fail to be able to question the accuracy of ratings. Thus, even if the credit rating agency discloses its ratings methodologies and procedures fully and accurately, this information is meaningless to the investors. In addition, even if credit rating agencies fully and fairly disclose the inherent conflict of interest, the regime can only work when investors can adequately perceive and evaluate that information.

For example, even if CRAs fully disclose the level of interaction that goes on between the CRA and an arranger when rating a structured product, investors may not fully appreciate that this practice could result in and allow for ratings shopping by arrangers.

More importantly, even if credit rating agencies fully and fairly disclosed all information, and the investors have adequately perceived the rating performance and the inherent conflicts of interest that impacted the agencies' ratings, “disclosure can only deter CRAs to the extent that investors can penalize them for producing low integrity ratings”. Unless investors can force issuers to withdraw business that compromises their ratings from rating agencies, disclosure will not produce optimal incentives for CRAs to maintain integrity in their rating processes. Therefore, the mandatory disclosure requirement cannot work by itself. It cannot adequately deter the agencies from reaping the gains of compromised ratings. Credit rating agencies should be penalized if they fail in meeting the disclosure requirement.

---

54 Darcy, supra note 25
56 Darcy, supra note 25
57 Ibid
requirement should always be used in connection with the liability requirement, which can make sure the participants who are responsible for disclosure will behave with due diligence.

In conclusion, the disclosure requirement alone is not sufficient for improving the quality of credit ratings. It should be used in connection with liability regulations.
II Absence of Accountability: a study of previous cases

By examining the cases against rating agencies, it is not hard to find out that it has been very difficult to hold credit rating agencies liable for their conduct.

Credit rating agencies have been sued relatively infrequently. In the recent 30 years, there were only 19 federal cases against the three major rating agencies (Moody’s, S&P’s and Fitch) concerning security rating. More specifically, more than half of them happened after the crisis. (11 cases were decided after 2007) 58.

---

With respect to the basis of the cases, negligence liability has been the most common allegation. Nine cases have been argued for negligence liability. In addition, fraud liability has also been alleged against credit rating agencies. Among the 19 cases, 6 cases have been argued on the ground of common law fraud, two alleged aiding and abetting fraud, and two other cases alleged claims under section 10(b) and section 10(b)-5. Moreover, claims have also been asserted on ground of “control person liability” under Section 15, seller allegations under section 11, defamation and breach of contract.

More importantly, credit rating agencies were held liable infrequently. Among the 19 cases, the investors succeed in only one case and in two other cases their claims are partly granted. Specifically, In Abu Dhabi Commercial Bank, v. Morgan Stanley(2010), investors’ claim of common law fraud against Moody’s and S&P succeeded; In Re National Century Financial Enterprises, Inc., Investment Litigation(2008), Moody’s motion to dismiss the claims asserted against it by investors (Lloyds) was granted as to section 10(b), fraud, and New...
Jersey blue sky law claims. The motion was denied as to investor's negligent
misrepresentation and Ohio blue sky law claims. Fitch's motion to dismiss the claims asserted
against it by the New York Funds was denied\textsuperscript{67}; In County of Orange v. Mcgraw Hill (1999),
the court granted rating agency’s motion for summary judgment on investor's breach of
contract and professional negligence claims. The Court denied rating agency's motion for
summary judgment on plaintiff's breach of contract and professional negligence claims\textsuperscript{68}.

By reviewing the case law regarding credit rating agencies, it is not hard to find that
generally the courts have not held credit rating agencies accountable for alleged professional
negligence or fraud and that plaintiffs have not prevailed in litigation against them. Given the
rapid expansion of rating agencies in recent years, the credit rating agencies still are "largely
unregulated" and operate with surprisingly little government regulation. The tort system and
the market serve as the only checks on rating agencies. Moreover, instead of being held to a
potential negligence liability, there is even a statutory exemption under the Securities Act of
1933 for Section 11 claims against credit rating agencies that have been designated
"NRSROs." The following section will focus on the negligence liability of the rating agencies,
especially the expert liability under section 11.

\textsuperscript{67} In Re National Century Financial Enterprises,(2010) U.S. Dist. LEXIS 39524 (QL)
\textsuperscript{68} Compuware Corporation, v. Moody's (2007 ) 499 F.(3d) 520
III Justifications for imposing expert liability under section 11 on rating agencies

Rule 436(g) under the Securities Act, adopted in 1982, provides an exemption for credit ratings provided by NRSROs from being considered a part of the registration statement as an expert report prepared or certified by a person within the meaning of Sections 7 and 11 of the Securities Act. The exemption currently does not apply to credit rating agencies that are not NRSROs. Recently, a proposal to rescind this rule has been raised. In the concept release on possible repeal of Rule 436(g), the SEC argued that there is no longer sufficient basis to exempt NRSROs from the expert liability under Section 11 of the Securities Act. Whether there is sufficient basis to remove the exemption and impose expert liability on rating agencies remain controversial. However, as analyzed below, I believe that the repeal of Rule 436(g) is appropriate and necessary.

3.1 Original reasons for exemption are not sufficient

Firstly, the Commission, in proposing Rule 436(g), stated that the rule was necessary to make the voluntary disclosure requirement about security ratings meaningful by reducing the risk

---

71 Ibid
for registrants to disclose. 72 Without the exemption provided by Rule 436(g), the Commission was concerned that registrants would not voluntarily disclose security ratings in their registration statements because of the liability concerns. 73 As mentioned before, mandatory disclosure requirement has been proposed. If this proposal is adopted, there is no need to provide a means to encourage disclosure about credit ratings. Thus, the rationale cited by the Commission in 1981 is no longer applicable.

Secondly, when Rule 436(g) was adopted in 1982, the Commission believed that the liability that was already applicable to NRSROs was sufficient for the protection of investors. At that time, the Commission noted that NRSROs were subject to liability under both Section 10(b) of the Exchange Act and the Investment Advisers Act. 74 However, the fact is that while NRSROs remain subject to Section 10(b) of the Exchange Act, as shown in the previous section, NRSRO have been sued relatively infrequently, and rarely have been held liable. In addition, NRSROs are no longer required to register as investment advisers, since the Congress provided an exclusion from the Advisers Act for NRSROs when it passed the Credit Rating Agency Reform Act of 2006. 75

Considering the current situation, which is quite different from the original concerns of the Commission, it is appropriate to repeal the rule. Therefore, the original reasons supporting adoption of Rule 436(g) no longer provide a sufficient basis to continue to offer the exemption to NRSROs.

73 ibid
74 ibid
75 Disclosure of Ratings in Registration Statements, supra note 72
3.2 Imposing liability would improve investor protection and ratings quality

Firstly, people arguing that credit rating agencies should not be subject to Section 11 liability insist that rating agencies should remain largely unregulated. They believe that rating agencies are motivated to provide accurate and efficient ratings as their profitability is directly tied to reputation.\(^{76}\) However, as demonstrated in the first section, the ineffectiveness of the "reputational capital view" of credit agencies, and the conflict of interest problem show that it is necessary to increase potential liability for negligence and misrepresentation against credit rating agencies. As analyzed before, the fear of losing reputational is not sufficient to constrain the rating agencies from irresponsible ratings. More importantly, imposing liability can make up for the deficiency of the “Reputational model”. The risk of liability would motivate rating agencies to improve the quality of their ratings and analysis, regardless of the reputational concerns.\(^{77}\)

Secondly, people are concerned that a risk of greater liability for credit rating agencies may undermine competition. In face of an increased risk of legal liability, credit rating agencies may decide to exit the rating business when they are unable to bear the risk of liability; The elimination of the safe harbor for NRSRO may give firms considering entering the ratings business less incentive to begin. However, I doubt that imposing more liability on rating agencies would make a big difference on competition in the rating industry. For instance, in the 30 years since the rule 346(g), which exempt the NRSRO from liability under section 11,

\(^{76}\) Schwarcz, supra note 55

was adopted, the domination of the three rating agencies has not changed. Actually, the market share of the major NRSRO has become more concentrated in the 30 years with the exemption. Thus, we should not expect that the repeal of the rule would result in a big difference on concentration. More importantly, even though the elimination of the rule would create competitive disadvantage and result in less competition among the NRSROs, it may not be a bad thing with respect to the quality of ratings, since, as analyzed before, fostering competition is not a good option for improving rating quality and may result in worse ratings. Therefore, imposing stricter liability would not result in worse rating by affecting the market share of the dominating NRSROs. On the contrary, removing the safe harbor for NRSROs will make the NRSRO act as carefully as other credit rating agencies, which is good for improving the quality of credit ratings.

Thirdly, NRSROs should not simultaneously benefit from ratings-dependent regulation and be insulated from lawsuits alleging negligence or misrepresentation. With respect to the great reliance on credit rating for the investors, which is hard to be eliminated in the short term, the only way for improving rating quality is to make the rating agencies subject to stricter liability, thereby making the agencies act more responsibly. Therefore, the importance of credit rating makes it even more necessary to impose more liability on NRSROs.

Fourthly, given the disclosure requirement, which offers an important way to improve credit ratings, it is arguable whether it is still necessary to impose strict expert liability on rating agencies. I believe it is still necessary. As argued above, transparency is not the solution to every problem. Credit rating is highly complicated and professional. Even though all the rating models, procedures and relevant data are disclosed to the public, it is still difficult for the public to fully understand the ratings and access the quality of the ratings. Imposing
liability, used in connection with the disclosure requirement, is better for improving rating quality. For example, Section 11 was designed to encourage careful preparation of the registration statement, to assure that disclosure regarding securities is accurate. Subjecting NRSROs to liability under Section 11 is good for implementing the disclosure requirement.

Finally, even though all the other new government regulations and proposed amendments may enhance the integrity of the rating process, these prospective actions offer little comfort to the millions of investors already suffering in the wake of the subprime mortgage crisis. In this respect, subjecting rating agencies to stricter liability is absolutely necessary.

In conclusion, increasing the risk of liability under the federal securities laws could significantly improve investor protection. Enhancing the accountability of NRSROs may help to address concerns on the quality of credit ratings. Imposing liability can be used as the last defense to deter the rating agencies from irresponsible rating, when all the other regulatory approaches are insufficient and exhausted. Therefore, making NRSROs more accountable in the courts is an indispensable way to improve ratings quality.

3.3 Expert liability is consistent with the nature of Credit Ratings

One argument exempting credit rating agencies from expert liability is that “A credit rating is a current opinion of relative future credit risk. It is not a statement of fact, or even a prediction of fact. It is not a statement or prediction that can be proved as “right” or “wrong”
They believe that credit ratings are different from other professional opinions which are subject to expert liability. However, by examining the nature of credit rating and comparing it with other profession opinions, I believe expert liability is consistent with the nature of credit ratings.

3.3.1 Scope of section 7 and section 11

Section 7 of the Securities Act covers “any person whose profession gives authority to a statement made by him”79 These persons are referred to as experts for the purpose of the securities laws. Registrants are required to file the consents of experts as exhibits to their registration statement. Section 11 imposes liability to parties who have a direct role in a registered offering.80 Liability under Section 11 extends to the issuers, officers and directors who sign the registration statement, underwriters, and persons who prepare or certify any part of the registration statement or who are named as having prepared or certified a report or valuation for use in connection with the registration statement.81 As summarized by Moody’s in their comment on the Concept Release on Possible rescission of rule 346(g), the three categories of experts fall in to the scope of section 7 and section 11 of the securities act. The first category certifies an issuer’s representation contained in a registration statement. The second category prepares part of the registration statement. The third category covers persons who prepare or certify a report “for use in connection with a registration statement”.82 I

---

78 Moody’s :“ Comments of Moody’s Investors Service on SEC’s Possible Rescission of Rule 436(g) ”available at <http://v3.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_121792> last access August 16,2010
79 Information required in registration statement,15 U.S.C. 77g.
80 Securities Act ( U.S.), U.S. C.,1933, c. 38, s. 1(15 U.S.C.A. 77a
81 Harold S.Bloomenthal, The SEC integrated disclosure system , (New York: Clark Boardman company, 1982), at 5-2
82 Moody’s comment, supra note 78
agree that the CRAs cannot be included into the first two categories, as they do not certify representations of the issuer nor prepare the registration statement. However, I argue that the CRAs do prepare reports “for use in connection with a registration statement”, which enable them to fall into the third category, as the issuers do rely on CRAs ratings to prepare the registered offering when they are required to get certain ratings to fulfill the requirement, which has been stipulated in the rating-dependent regulations.83

3.3.2 Common law opinion

In Abu Dhabi Commercial Bank v. Morgan Stanley (2009) the court held that “Opinion may still be actionable if the speaker does not genuinely and reasonably believe it or if it is without basis in fact.”84 Thus, from the perspective of common law, the nature of credit rating, which is referred as “opinions”, should not deter the court from holding rating agencies liable.

3.3.3 Comparisons with other experts that are subject to liability under section 11

The primary function of rating agencies is to assess “the creditworthiness of companies and public entities that issue debt.”85 The agencies grade the issuer and provide investors with ratings, which range from an extremely low credit risk to a highly speculative investment. In

83 See previous section 1.2.3
the SEC’s view, “NRSROs represent themselves to registrants and investors as experts at analyzing credit and risk”\(^{86}\) “While the agencies gave ‘opinions’, they did so as professionals being paid to provide their opinions to a client.”\(^{87}\) Investors rely on the analysis of credit and risk provided by credit rating agencies as a key reference of their investment decision.

Similar with other professional opinions upon which investors rely, such as legal opinions, valuation opinions, fairness opinions and audit reports, credit ratings are also exercises of highly advanced intellectual judgment and professional skills based on special education, training and experience. Credit ratings are not meant to be based on feeling or irresponsible opinion. Instead, credit ratings are supposed to be the result of rigorous analysis of financial and historical data.

Therefore, NRSROs and other credit rating agencies are professionals, same as the other experts subject to liability under Section 11. Given the nature of credit rating agencies, there is no basis to exempt NRSROs from the provisions of the Securities Act applicable to experts.\(^{50}\)

In conclusion, the original basis to exempt NRSROs from the expert liability under section 11 is no longer sufficient; expert liability is consistent with the nature of credit ratings; more importantly, imposing expert liability is necessary for improving rating quality. Thus, the proposal to rescind the rule 436(g) should be adopted.


IV Regulatory obstacles for alleging the claims under section 11

In this section, I will argue that even if the proposal to rescind the rule 436(g) is adopted, there are still other regulatory obstacles that make it extremely hard to make credit rating agencies accountable under section 11.

4.1 First amendment protection

The First Amendment established a freedom of speech, and especially provides a constitutional privilege to the press as a matter of freedom of the press. Under the First Amendment protection, the press is free from tort liability.\textsuperscript{88} The rating agencies always claim such protection to escape from liability. As illustrated below, plaintiffs, both issuers\textsuperscript{89} and investors\textsuperscript{90}, generally have been unsuccessful in suits against these agencies. However, in a number of recent cases, the courts have denied the first amendment protection for credit rating agencies, which is appropriate in light of the CRAs’ characteristics.

---


\textsuperscript{89} In cases where the issuers sued the CRAs, as illustrated in the following section, the courts analogized the CRAs and have consistently granted the First Amendment protection. In cases where investors claim against CRAs, the courts also have held that the Freedom of Speech bars any potential liability. For instance, \textit{In re Enron Corporation Securities, and Derivative & ERISA Litigation}(2005)511 F. Supp. 2d 742; (Investors, claim damages caused by a breach of the duty of care, caused by a misrepresentation of the CRAs ); \textit{In re Abu Dhabi Commercial Bank, Civ. (2009)7508 (SAS) No. 08, 2009 WL 2828018};(two institutional investors brought a class action against rating agencies, asserting claims including negligent misrepresentation, negligence); \textit{In re National Century financial enterprises}(2008) No.2:03-MD-1565(Investors brought actions alleging that credit agencies’ statement induced them to invest)
Commentators have expressed skepticism that Section 11 liability would violate the NRSROs’ First Amendment rights. The following sections would demonstrate that subjecting NRSROs and other CRAs to the strict liability scheme of Section 11 would not violate the First Amendment. More importantly, the following section would answer SEC’s concerns which it provided in the Concept release on possible rescission of Rule 436(g) under the securities act of 1933 (2009), “How would any claims of First Amendment protection applicable to NRSROs be impacted by potential Section 11 liability?” As illustrated in LaSalle v. Duff & Phelps (1997), where the plaintiff asserted a negligent misrepresentation claim against the Duff & Phelps, a credit rating agency but not NRSRO, the first amendment protection remained an issue while the defendant was subject to the expert liability under section 11. Thus, even if the proposal to rescind the rule 436(g) is adopted, the First Amendment protection is still a regulatory obstacle to make credit rating agencies accountable under section 11.

4.1.1 First Amendment Protection Defense

Historically, CRAs enjoyed First Amendment protection from tort liability since Jaillet v. Cashman in 1923. In Jaillet v. Cashman, the complaint alleged that the defendant, an unincorporated association, negligently published on its tickers the erroneous report. The court extended the status of press to the defendant, held that” the relation of defendant to the public was the same as that of a publisher of a newspaper and that it was not liable to one with whom it had no contract or fiduciary relationship for an unintentional mistake in its

91 Moody’s comment, supra 78


93 Jaillet v. Cashman, (1923)235 N.Y. 511; 139 N.E. 714; 1923 N.Y. LEXIS 1219
A number of courts have agreed with this position and applied the Supreme Court's actual malice standard for journalistic liability in determining the agencies' liability for the accuracy of their credit ratings. The decision in *Jaillet v. Cashman* has been reiterated in many cases, such as *Jefferson County School District No.R-1 v. Moody’s Investors Services, Inc.*, *in re Enron Corporation Securities, and Derivative & ERISA Litigation*, *Compuware Corporation v. Moody’s Investors Services, Inc.*

### 4.1.1 Denial of Press Privilege in Credit Rating Agency Cases

In *LaSalle v. Duff & Phelps* (1997), the plaintiff asserted a negligent misrepresentation claim against the Duff & Phelps, a credit rating agency, based on its credit rating of bonds. Duff & Phelps argued that the publisher of a credit rating is a member of the free press, thereby entitled to the privileges and immunities accorded the press. The Court rejected Duff & Phelps' argument for the reasons listed below. First, the CRA was hired to issue a rating. “Duff & Phelps' rating was privately contracted for and intended for use in the private placement Offering Memoranda, rather than for publication in a general publication”; second, the CRA knew that its rating would be disseminated to the public as part of the official statements and therefore played an active role in the dissemination of the allegedly

---

94 ibid
95 *Jefferson County School District No. R-1 v. Moody’s Investor’s Services, Inc.*, (1999)175 F.3d 848; (The court held that “claims for intentional interference with contract and for intentional interference with prospective business relations were also barred by First Amendment”).
96 *In re Enron Corporation Securities, Derivatives & ERISA Litigation*, (2005)511 F. Supp. 2d 742; (The court held that “absent actual malice, national credit rating agencies were entitled to First Amendment protection against lender’s claims regarding negligent misrepresentation of debtor's creditworthiness”).
97 *Compuware Corporation v. Moody’s Investors Services, Inc.*, (2007)499 F. 3d 520; (The court held that “without question Moody’s involves activities protected by the First Amendment,” and applied the constitutional protection to the extent of contractual relationship by saying that “the plaintiff could not avoid the First Amendment by asserting an implied contractual duty to perform the rating function competently”).
99 Ibid
fraudulent official statements. Third, the court rejected Duff & Phelps' attempt to apply the "actual malice" standard. In *New York Times v. Sullivan*, the Supreme Court held that in order for a public official to state a claim of libel against a publisher for a defamatory falsehood about his or her official conduct, the official must prove that the "statement was made with 'actual malice', that is, with knowledge that it was false or with reckless disregard of whether it was false or not." Instead of following the actual malice standard in *New York Times v. Sullivan*, the court of *LaSalle v. Duff & Phelps*, referred to *Dun & Bradstreet, Inc. v. Greenmoss Builders*, in which the Supreme Court held the actual malice standard inapplicable to a credit reporting agency. In conclusion, the court held that *Duff & Phelps* is not immunized from liability as a "publisher".

Furthermore, in 2003, the court of *American Savings Bank FSB v. UBS PaineWebber Inc*, held that the rating firm’s activities was not typical newsgathering and therefore the firm “was not entitled to assert the journalist’s privilege.” The court suggested that rating agency’s activities associated with the structuring of a transaction are distinguished from ordinary journalistic activity. Firstly, the rating agencies only "reports on" specific transactions for which it has been hired. Unlike a business newspaper or magazine, which would cover any transactions deemed newsworthy, the rating agency only "covers" its own clients. The vast majority of rating agency's rating activities are initiated by client request. Secondly, the rating agency's information-disseminating activity does not seem to be based on a judgment about newsworthiness, but rather on client needs. The rating agency takes an active role in

100 Ibid
102 *Dun & Bradstreet, Inc. v. Greenmoss Builders*(1985) , Inc., 472 U.S. 749, 762, 105 S. Ct. 2939, 2947, 86 L. Ed. 2d 593 (Court permitted recovery of damages in defamation case against credit rating company for false statements found in credit report on lesser showing than “actual malice” because information was “solely in the individual interest of the speaker and its specific business audience”
the planning of the transactions it analyzes, a role that is different from traditional journalism. A third reason is that almost all CDOs and similar instruments are placed privately and confidentially. Upon these considerations, the court concluded that the rating agency was not entitled to assert the journalist's privilege.

Another recent decision made in a similar context is *Commercial Financial Services, Inc. v. Arthur Andersen LLP* (hereinafter “*CFS v. Arthur Andersen*”) in 2004. In *CFS v. Arthur Andersen*, the fact that the CRAs were hired to provide rating service was the critical basis upon which the court rejected the CRAs’ press privilege defense. The court pointed out that “the agencies had been asked to rate the bonds, at the company's request and expense. While the agencies gave ‘opinions’, they did so as professionals being paid to provide their opinions to a client, and the First Amendment did not shield them from potential liability.”

Most recently, in September 2009, First Amendment protection for Moody’s and S & P was rejected by the court *In re Abu Dhabi Commercial Bank*. This case warrants attention because it was the first court decision regarding the responsibility of CRAs on rating structured finance products since the occurrence of the current financial crisis. The court held that “where a rating agency has disseminated the ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the same protection.” This case reiterated the principle that a CRA cannot be afforded the same protections as a

---


105 Ibid

106 *In re Abu Dhabi Commercial Bank*, Civ. (2009)7508 (SAS) No. 08, 2009 WL 2828018. In this case, CRAs rated the structured finance products issued by a structured investment vehicle, and the credit ratings were provided in connection with a private placement to a select group of investors, the plaintiffs.

107 Ibid
press when a CRA is hired to issue a credit rating that would be included in the offering materials for the security.\textsuperscript{108}

### 4.1.2 Characteristics of the credit rating agencies distinguish them from traditional media

According to the above mentioned cases, whether First Amendment protection for the traditional bond rating agency is appropriate is a matter of doubt. To decide whether First Amendment protection can be applied to CRAs, the nature of the business carried by CRA should be considered. This section examines the essential of credit rating agencies in their rating business practice. The above mentioned cases have pointed out several features distinguishing the agencies' ratings from ordinary publishers' news pieces and editorials. First, the major rating agencies receive payment from the client, whereas most journalists do not receive compensation from their subjects. Second, in contrast with the ordinary journalists, the rating agencies are far more involved, as their activities associated with assisting the structuring of a transaction. Finally, law and the financial markets value the agencies' ratings more than mere opinions and treat them instead as a “certification” or “benchmark” of transactions.\textsuperscript{109}


\textsuperscript{109} Jonathan M. Barnett. “Certification Drag: The Opinion Puzzle and Other Transactional Curiosities” (2007)33 J. Corp. L. 95, 139
In conclusion, I believe that courts should recognize these different characteristics of rating agencies and not award the rating agencies First Amendment protection reserved for bona fide journalists.\textsuperscript{110}

4.2 Absence of a common standard

Liability under Section 11 is strict. All that the plaintiff need to show is the existence of a material misstatement or omission. Unlike the cause of action permitted under the more commonly used \textit{Section 10b of the Securities Exchange Act}, plaintiffs invoking \textit{Section 11 of the 1933 Act} need not prove scienter, reliance, causation, or privity.\textsuperscript{111} However, in order to establish a claim for professional negligence, the standard of that duty must be considered. In particular, to assert a section 11 claim under securities act against an expert, the plaintiff must establish that a statement or statements in registration statement were false or misleading with respect to a material fact, or that the registration statement omitted material information which is required to be included therein.\textsuperscript{112}

Professional experts who are accountable under section 7 and section 11 of the Securities Act, such as auditors, engineers, actuaries, valuation experts, and lawyers, apply a common set of professional standards with the expectation of reaching common conclusions. An expert can defend on the ground that he made a reasonable investigation and, after the reasonable investigation, believed and had reasonable ground to believe that the statements in question


\textsuperscript{111} Richard Cordero” Who may maintain action under 11(a) of Securities Act of 1933 (15 U.S.C.A. 77k(a)) in connection with false or misleading registration statements”(1993) 111 A.L.R. Fed. 83

\textsuperscript{112} Bloomenthal, supra note 81
were true and were not misleading.\textsuperscript{113} For instance, there is the generally accepted accounting standards which could enable the accounting firms auditing the same company generally all reach the same conclusion. Thus, “as a minimum, with respect to accountants, this requires that standard auditing procedures to be followed and that the accountants verify that which is readily verifiable rather than merely accepting the representations of the management.”\textsuperscript{114} In other words, one does not expect much diversity in opinions among these experts and neither the market nor regulators would applaud diverging opinions from these experts.\textsuperscript{115}

In contrast, the credit ratings are independent opinions that are not determined in accordance with an industry “standard”. Multiple credit rating agencies may well express multiple, different opinions on the same question. The substance of CRA methodologies and models is not regulated. Credit rating agencies are expected to compete with each other on the basis of, among other things, the quality of their different rating methodologies and models.\textsuperscript{116} Promoting the dissemination of diverse credit opinions, however, is at odds with imposing liability on rating agencies under section 11 of the securities act.

The absence of common standard makes it particular difficult to claim negligence liability of credit rating agencies under section 11 of the security act. For instance, in \textit{Orange County}, plaintiff sued defendant financial rating agency (S&P) for breach of contract and professional negligence.\textsuperscript{117} In the examination of the professional liability of S & P, the court held that “In order to establish a claim for professional negligence, a plaintiff must demonstrate the duty of the professional to use such skill, prudence and diligence as other members of his

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{113} Bloomenthal, supra note 81
\item \textsuperscript{114} Ibid, at 5-3
\item \textsuperscript{115} Moody’s comment, supra note 78
\item \textsuperscript{116} Ibid
\item \textsuperscript{117} County of Orange v Mcgraw Hill Companies, (1999) 245 B.R. 151; 1999 U.S. Dist. LEXIS 19975
\end{itemize}
\end{footnotesize}
profession commonly possess and exercise”\textsuperscript{118} In the end, the court found that “a reasonable jury could not conclude by the necessary standard that the service knew of a high degree of probable falsity when it rated the county's debt”. \textsuperscript{119}

Therefore, in order to hold the rating agencies accountable, the court should take the distinct nature of credit rating agencies, the absence of common standard, into account. When examining the professional liability of the agencies, instead of applying the common standard, the court should evaluate the professional acceptable conduct standard of CRAs on the basis of performance, methodology and experience of traditional CRAs.


\textsuperscript{119} Ibid
Conclusion

Credit rating agencies greatly underestimated the risks associated with subprime securities, contributed to the collapse of the housing market, and thereby helped trigger a global financial crisis. Obviously, the previous “reputational model” is not sufficient to constrain credit rating agencies from irresponsible ratings. Improving the quality of credit rating has become a highly urgent issue. Amendments aimed at reducing reliance on rating agencies, enhancing competition and increasing transparency have been proposed. However, these proposed amendments are not sufficient to manage the conflicts of interest problem and regulate credit rating agencies. Making credit rating agencies more accountable in the courts is an indispensable way to improve ratings quality. Given the fact that credit rating agencies have been sued relatively infrequently, and rarely have been held liable, in order to impose liability on credit rating agencies, obstacles for alleging the claims need to be removed. Statutory exemption under the Securities Act of 1933 for Section 11 claims against credit rating agencies that have been designated to "NRSROs" should be eliminated. However, the elimination of the exemption is not sufficient to prove expert liability against rating agencies. Even if the proposal to rescind the rule 436(g) is adopted, there are still other regulatory obstacles that make it extremely hard to make credit rating agencies accountable under section 11. Pushing credit rating agencies toward accountability is a long and winding road. Rating agencies receive first amendment protections as a member of the media, and are not held liable unless found to be reckless. The higher actual malice standard still applies to tort claims against them. Moreover, the absence of common standard make it particular difficult to claim negligence liability of credit rating agencies under Section 11 of the Securities Act.
In conclusion, the proposal which rescinds rule 436(g) that currently exempts NRSROs from expert liability under *Section 11 of the Securities Act* is necessary but not sufficient for establishing an accountability framework to eliminate irresponsible ratings. In addition to the proposal, more importantly, the courts should recognize the different characteristics of rating agencies and not award the rating agencies First Amendment protection reserved for bona fide journalists. Moreover, in order to hold the rating agencies accountable, the court should take the distinct nature of credit rating agencies, the absence of common standard, into account. When examining the professional liability of the agencies, the court should evaluate the professional acceptable conduct standard of CRAs on the basis of performance, methodology and experience of traditional CRAs.
Bibliography

Legislation


*Information required in registration statement*, 15 U.S.C. 77g


*Money market funds, rules and regulation under investment company act of 1940*, 17 C.F.R. § 270.2a-7(a)(10), (a)(21), (c)(3)(i)

*Net Capital Requirements for Brokers or Dealers*, 17 C.F.R. § 240.15c3-1

*Regulation S-K*, 17 C.F.R. § 229.10


Jurisprudence


[Arthur Andersen LLP v. Standard & Poor's Credit](2003) 260 F. Supp. (2d) 1123

[California Public Employees Retirement System v. Moody's](2009), U.S. Dist. LEXIS 110756 (QL).


[Compuware Corporation v. Moody's](2007) 499 F.(3d) 520

[County of Orange v. Mcgraw Hill](1999) U.S. Dist. LEXIS 23350; 27 Media L. Rep. 2612


[In Re Enron Corporation Securities](2005) 511 F. Supp.(2d) 742

[In Re Lehman Brothers Securities and Erisa Litigation](2010), 684 F. Supp. 2d 485 (QL).

[In Re Moody's Corporation Securities Litigation](2009) 612 F. Supp.( 2d )397

[In Re National Century Financial Enterprises.](2010) U.S. Dist. LEXIS 39524 (QL)

[In Re Wells Fargo Mortgage-Backed Certificates Litigation](2010), Fed. Sec. L. Rep.95725 (QL).

[Jaillet v. Cashman,](1923)235 N.Y. 511; 139 N.E. 714; 1923 N.Y. LEXIS 1219

[Jefferson County School District No. R-1 v. Moody's Investor's Services](1999) 175 F.(3d) 848

[King (County) v. IKB](2010) , Civ. 8387 (SAS), Civ. 8822 (SAS); U.S. Dist. LEXIS 48999(QL).


Secondary Material: Monographs

Bloomenthal, Harold S. The SEC integrated disclosure system , (New York: Clark Boardman company, 1982)


"The rating game; Twentieth Century Fund Task Force on Municipal Bond Credit Ratings. (New York: Twentieth Century Fund, 1974)"

**Secondary Material: Articles**

Barnett, Jonathan M. “Certification Drag: The Opinion Puzzle and Other Transactional Curiosities” (2007) 33 J. Corp. L. 95, 139


Other Material


