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Policing the Ratings Agencies: The Case for Stronger Criminal Disincentives in the Credit Rating Market

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COMMENTS

POLICING THE RATINGS AGENCIES: THE CASE FOR STRONGER CRIMINAL DISINCENTIVES IN THE CREDIT RATING MARKET

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"It could be structured by cows and we would rate it."

—Standard & Poor's analyst[1]

The purpose of this Comment is to evaluate how criminal disincentives affect the credit ratings agencies. The Comment explores how the criminal law influenced the behavior of the ratings agencies before and during the subprime collapse and the credit crisis. The failures of the ratings agencies have led to a widespread push for regulatory reform, but the possibility of a targeted criminal law has been largely absent from the scholarly and political discourse. This Comment examines why there have been no criminal prosecutions against actors at the ratings agencies, particularly in light of their heavily criticized role in the credit crisis. In finding criminal liability difficult to establish under the existing law, this Comment suggests that a tailored criminal law targeting the ratings agencies would provide a justifiable and powerful control mechanism for high-risk misconduct. Although strict civil laws could similarly deter misconduct, compliance with and enforcement of civil regulations would be inefficient and expensive.

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[1] In a now-infamous email exchange between two Standard & Poor's analysts, one wrote, "It could be structured by cows and we would rate it." Another replied, "Let's hope we are all wealthy and retired by the time this house of cards falters." *See* Andrew Taylor, *Credit Raters Get Grilled on Capitol Hill*, ASSOCIATED PRESS FIN. WIRE (Oct. 22, 2008, 3:10 PM), http://seattletimes.nwsource.com/html/businesstechnology/2008296967_apmeltdowncreditagencies.html.

I. INTRODUCTION

When two Bear Stearns hedge funds collapsed in July 2007, it quickly became clear that investment products tied to subprime mortgage loans were overvalued.[2] What little was left of the once-booming business of structuring complex securities and collateralized debt obligations came to a screeching halt. The market for these investment products dried up and investors watched as the ratings agencies finally slashed credit ratings.[3] Unfortunately, for most it was already too late to withdraw. Investors suffered crippling losses on supposedly safe investment products that bore the stamps of ratings-agency approval. How could this have happened? Weren't the ratings agencies supposed to prevent just this kind of market-wide valuation crisis? What were these gatekeepers doing with nonpublic information if not protecting the investing public? The ratings agencies became the target of scholarly, political, and mass-media censure.[4] Critics began to reevaluate the role of the ratings agencies and how the regulatory framework in which they operate did not adequately control misconduct.

Despite this widespread and often scathing criticism of the credit ratings agencies (CRAs)[5] for their role in the subprime and credit crises, there have been no criminal prosecutions for CRA misconduct.[6] The ratings agencies have taken a major blow in the court of public opinion,[7]

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[2] *See* Paul Tharp, *Bad News Bear—Funds Now Worthless*, N.Y. POST, July 18, 2007, at 35. It was not just high-risk hedge-funds imperiled by the subprime collapse; even money-market funds were invested in subprime debt. *See* David Evans, *Money Markets Face New Threat—Subprime Crisis Could Hit Them*, CHI. SUN-TIMES, Aug. 26, 2007, at A36.

[3] *Dow Dips, but NASDAQ Stages a Rally*, N.Y. TIMES, Oct. 18, 2007, at C13 (noting that "Standard & Poor's cut the ratings on 1,713 classes of securities backed by mortgages issued in the first six months of [2007]").

[4] *See generally The Role of Credit Rating Agencies in the Structured Finance Market: Hearing Before the Subcomm. on Capital Mkts., Ins. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 110th Cong. (2007); Editorial, *AAA Oligopoly*, WALL ST. J., Feb. 26, 2008, at A18.

[5] In referring to the CRAs, this Comment limits its scope to the three major players. The ratings industry "is dominated by three agencies—Standard & Poor's, Moody's Investors Service, and Fitch Ratings." David Teather, *SEC Seeks Rating Sector Clean-Up*, GUARDIAN, Jan. 28, 2003, *available at* http://www.guardian.co.uk/business/2003/jan/28/usnews.internationalnews.

[6] *See, e.g.*, Michael Hirsh, *Drop Moody's Into the Volcano: Why Wall Street's Big Ratings Agencies Should Go the Way of Arthur Andersen After Enron*, NEWSWEEK, Sept. 30, 2009, *available at* http://www.newsweek.com/id/216486.

[7] *See, e.g.*, Barbara Kiviat, *The SEC's Next Challenge: Fixing the Rating Agencies*, TIME, Apr. 15, 2009, at 24 (noting confidently that "[a]ny list of people and institutions to blame for the financial crisis would include credit-rating agencies").

and investor confidence in their ratings has plummeted.[8] Civil litigation against the CRAs has marched forward: individual investors have sued the CRAs in lawsuits for negligence, fraud, and deceit;[9] class actions have named the CRAs as co-defendants;[10] and the federal government has sued the CRAs for civil violations.[11] The failures of the ratings agencies precipitated a push for regulatory reform,[12] but the possibility of reshaping or strengthening the criminal disincentives that control the ratings agencies has not been under serious consideration.[13] The integrity of our markets is so dependent on the good faith of the CRAs that their wrongdoing, which we might elsewhere address with civil liability, should face stricter criminal disincentives. The absence of any criminal prosecutions, let alone convictions, under the existing law should signal to Congress that the existing criminal law is not providing a sufficient check on the ratings agencies.

Not only the CRAs but the entire financial sector faced public and academic scrutiny for the credit crisis. The investing public was furious at Wall Street when the economy began to cave in; many wanted heads on the chopping block.[14] Many top executives seemed to be in a vulnerable

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[8] *See* Aaron Lucchetti & Serena Ng, *Triple-A Ratings Grade on a Curve, Making It Difficult to Assess Risk*, WALL ST. J., Oct. 6, 2007, at B1 ("[I]nvestors across the globe have lost confidence in the ratings.").

[9] One enraged former attorney, Ron Grassi, returned to practice and "set up a war room in his Tahoe City, California, home to single-handedly take on Standard & Poor's, Moody's Investors Service and Fitch Ratings." *See* David Evans & Caroline Salas, *Flawed Credit Ratings Agencies Reap Profits as Regulators Fail Investors*, BLOOMBERG NEWS, Apr. 29, 2009, *available at* http://www.bloomberg.com/apps/news?pid=20601101&sid=a6NdKd8CfR2A.

[10] *See, e.g.*, Kevin LaCroix, *Subprime Investors Sue Rating Agency*, D & O DIARY, June 8, 2008, *available at* http://www.dandodiary.com/2008/06/articles/subprime-litigation/subprime-investors-sue-rating-agency (describing a class action against the CRAs alleging failure "to conduct due diligence and willingly assign[ing] the highest ratings to such impaired instruments since they received substantial fees from the issuer").

[11] *See* Nathan Koppel & Chad Bray, *Judge Limits Credit Firms' 1st-Amendment Defense—Ruling in Cheyne Finance Case Lifts Protection for Ratings Not Made Public; Moody's, McGraw-Hill Stocks Fall*, WALL ST. J., Sept. 4, 2009, at C3 (describing a development in a class action including King County, Washington, as a plaintiff).

[12] *See, e.g.*, *AAA Oligopoly*, *supra* note 4, at A18 (discussing the need for reform in a regulatory system that functionally only allows three credit ratings agencies to operate).

[13] *See, e.g.*, Elizabeth M. Murphy, *Concept Release on the Possible Rescission of Rule 436(g) Under the Securities Act of 1933*, FED. REG., Vol. 74, No. 198, 53114–21, Oct. 15, 2009 (discussing the possibility of eliminating the CRAs' exemption from Sections 7 and 11 of the Securities Act of 1933 but making no mention of criminal liability).

[14] *See, e.g.*, Floyd Norris, *Being Kept in the Dark on Wall Street*, N.Y. TIMES, Nov. 2, 2007, at C1 ("Every financial disaster deserves a scapegoat, because someone must be blamed when bad investments are made. . . . If the agencies violated their own policies, they will be vilified for the conflicts of interest inherent in their being paid by the issuers of the

position, widely despised for their complicity. From an outsider's perspective, it looked like criminal prosecutions might bring some catharsis to the investors who suffered catastrophic losses. But as the crisis wore on and court dockets filled up with complex civil cases seeking damages, the high-stakes white-collar criminal cases that many anticipated did not materialize.[15] At first glance, potential white-collar criminal cases looked promising. There were substantial harms caused by decisions and actions of high-level market players: the only hurdle for prosecutors was proving the requisite *mens rea* of knowledge or intent.[16] And yet only a handful of cases went forward.[17]

This Comment argues that misconduct at the ratings agencies should be subject to criminal punishment even absent a *mens rea* of knowledge or intent.[18] When the entire investing public bears a risk of catastrophic losses for misconduct at the ratings agencies, there should be a strict criminal code controlling that conduct. The integrity of the markets depends on accurate credit ratings provided in good faith. With the stakes so high, criminal sanctions are justified both as deterrents and as desert for the wrongdoers. Traditional theories of punishment generally fall into two categories: (1)°utilitarianism and (2) retributive justice.[19] From a utilitarian perspective, the financial crisis was a perfect opportunity to exact punishments that deter future misconduct. There were market players who needed stronger deterrence at all levels of the market, from mortgage brokers all the way up to CEOs of bulge-bracket banks.

The case for retributive justice is perhaps even stronger with so many millions of people suffering harm from the misconduct: not only did

securities. If they did not, they will be derided as fools who could not see how risky the securities clearly were. In hindsight, of course.").

[15] *See* Andrew J. Ceresney, Gordon Eng & Sean R. Nuttall, *Regulatory Investigations and the Credit Crisis: The Search for Villains*, 46 AM. CRIM. L. REV. 225, 227 (2009) ("Despite the number of credit crisis-related investigations that law enforcement agencies have opened over the last two years, there have been remarkably few major regulatory actions or prosecutions to date.").

[16] Admittedly, the expense of pursuing a complex white-collar criminal case is another factor that plays some role in the decision to bring suit. *See* Ceresney, *supra* note 15, at 235 ("A number of significant obstacles, including the time and resources necessary to investigate and uncover wrongdoing, as well as the difficulty in apportioning blame and proving intent to defraud, confront successful law enforcement actions.").

[17] *See, e.g.*, Landon Thomas, Jr., *2 Face Fraud Charges in Bear Stearns Debacle*, N.Y. TIMES, June 20, 2008, at Al (describing the criminal case against two hedge fund managers at Bear Stearns who were catapulted into the spotlight in July 2007 when their hedge funds collapsed).

[18] *See infra* subpart III.B (recommending a *mens rea* of recklessness).

[19] *See generally* SANFORD H. KADISH ET AL., CRIMINAL LAW AND ITS PROCESSES § 2 (8th ed. 2007).

investors around the world suffer huge losses, but also the job market constricted, foreclosures skyrocketed, and citizens across the country became collaterally damaged.[20] The scene was set for a series of heated trials to captivate the public consciousness and restore some faith in the rule of law. But as of yet, no high-profile criminal cases have made it onto the dockets.

This Comment examines why there have been no prosecutions against individuals at the ratings agencies. The ratings agencies have a long and storied history in the American markets that dates back more than a century.[21] Part II of this Comment will explain how the CRAs operate, paying particular attention to their role leading up to the subprime and credit crises. This section will also describe how flaws in the CRA model led to their complicity in the crisis and will briefly outline some of the suggestions that scholars and politicians have offered to fix the ratings agencies.

Part III argues that the existing criminal law is not adequately deterring misconduct by CRAs. Subpart III.A will analyze criminal liability under the existing law. This section will focus on the difficulty of establishing *mens rea* and the causation component of criminal liability. The progress of civil suits against the ratings agencies indicates that a prosecutor could prove the *actus reus*[22] elements of a crime. The case for causation is slightly more difficult because there were so many factors at play in the decline and fall of the subprime and credit markets. However, the most significant barrier to a criminal conviction is the existing *mens rea* requirement of knowledge or intent.[23]

After exploring the theories of criminality, subpart III.B will propose a stronger set of criminal disincentives. This section will recommend that Congress enact a narrowly tailored federal criminal law targeted at the ratings industry. This Comment argues that such a law would be both more efficient and effective than a purely civil regulatory regime, and justifiable

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[20] *See* Jerry W. Markham, *The Subprime Crisis—Some Thoughts on a "Sustainable" and "Organic" Regulatory System*, 4 FL. INT'L U. L. REV. 381, 381–82 (2009) (describing the crisis's aftermath, including soaring unemployment, the devastation of retirement savings, and the cascading effects in the real estate market).

[21] *See* Richard Cantor & Frank Packer, *The Credit Rating Industry*, 19 FED. RES. BANK N.Y. Q. REV., 1, 1–4 (1994).

[22] Black's Law Dictionary defines *actus reus* as the "[t]he wrongful deed that comprises the physical components of a crime and that generally must be coupled with mens rea to establish criminal liability." BLACK'S LAW DICTIONARY 39 (8th ed. 2004).

[23] *See* Ceresney, *supra* note 15, at 243 (noting that in potential criminal cases "attributing blame and proving intent to defraud will present significant impediments to law enforcement").

under traditional theories of criminal punishment.[24] Although a more stringent civil regulatory system could deter misconduct by the CRAs, compliance with civil regulations would drive up systematic costs. Strict civil regulations are expensive and not necessarily effective.[25] Moreover, criminal punishment of wrongdoing in the ratings industry is justifiable in light of the high stakes. CRA actors can currently hide behind the sophistication of the rating process to defend against a criminal charge that requires knowledge or intent. Thus, I propose a criminal law prohibiting misconduct at the CRAs that requires only a *mens rea* of recklessness.

II. BACKGROUND

The subprime market collapse had immediate consequences on the financial sector. High-powered Wall Street executives were shown the door[26] and subprime lending shops were shut down.[27] Scholars, journalists, and politicians collectively tried to explain how the walls came tumbling down.[28] The causes identified include (1) high-risk, experimental structured finance, including complex instruments such as collateralized debt obligations and mortgage-backed securities, (2) the iron fist of mark-to-market accounting, and (3) recklessly loose lending standards.[29] In the search for villains, most scholars and critics agree that the storm would not

[24] *See infra* subpart III.C (discussing how utilitarian and retributive theories of punishment both support criminalization of CRA misconduct at a lower threshold than the existing law requires).

[25] *See, e.g.*, Diarmuid A. Hurley & David Boyd, *Sarbanes Oxley Act Section 404: Effective Internal Controls or Overriding Internal Controls?*, 16.2 FORENSIC EXAMINER 19 (2007) (finding that Sarbanes-Oxley's Section 404, "which was intended to create greater accountability of top management . . . . morphed into a detailed, cost-prohibitive, and ineffective [regulation system]").

[26] *See, e.g.*, Robin Sidel, Monica Langley, & David Enrich, *Two Weeks that Shook the Titans of Wall Street*, WALL ST. J., Nov. 9, 2007, at A1 (describing the "dual dramas at Citigroup and Merrill [Lynch & Co.]" that saw Stanley O'Neal and Charles Prince, two powerful Wall Street figures, forced out the door in the push for accountability).

[27] *See* Worth Civils & Mark Gongloff, *Subprime Shakeout: Lenders that Have Closed Shop, Been Acquired or Stopped Loans*, WALL ST. J., http://online.wsj.com/public/resources/documents/info-subprimeloans0706-sort.html (last visited Apr. 11, 2011).

[28] *See, e.g.*, PAUL MUOLO & MATTHEW PADILLA, CHAIN OF BLAME: HOW WALL STREET CAUSED THE MORTGAGE AND CREDIT CRISIS (2008); Charles W. Calomiris & Peter J. Wallison, *Blame Fannie Mae and Congress for the Credit Mess*, WALL ST. J., Sept. 23, 2008, at A1; Alan Greenspan, Editorial, *The Roots of the Mortgage Crisis*, WALL ST. J., Dec. 12, 2007, at A1.

[29] *See generally* MUOLO & PADILLA, *supra* note 28 (describing the complicated and often interconnected set of factors that led to the subprime collapse and the credit crisis).

have been nearly so fierce were it not for the failures of the credit ratings agencies.[30]

A. THE AMERICAN CREDIT RATINGS AGENCIES: THE DEBT MARKET'S TRIUMVIRATE

This Comment provides an abridged version of the interesting history of the CRAs and the circumstances that resulted in our current credit ratings system.[31] The ratings agencies' primary role in the credit markets is to provide information about the creditworthiness of securities and other debt instruments that are bought and sold.[32] The credit ratings industry has been dominated by three players—Standard & Poor's, Moody's Investors Service, and Fitch Ratings—and until recently, they were the "only three with an official stamp of approval from the SEC, designated as nationally recognised statistical-rating organisations, or NRSROs."[33] These agencies are supposed to serve a crucial function to investors—that of gatekeepers—a function in which they wholly failed leading up to the financial crisis.[34]

For any given corporation or security, the CRAs use information, including "the issuer's quality of assets, its existing liabilities, its borrowing and repayment history and its overall business performance," to generate a

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[30] *See, e.g.*, Marco Pagano & Paolo Volpin, *Credit Ratings Failures: Causes and Policy Options*, *in* MACROECONOMIC STABILITY AND FINANCIAL REGULATION: KEY ISSUES FOR THE G20, 129, 129 (2009), *available at* http://www.voxeu.org/reports/G20_ebook.pdf ("As the ongoing financial turmoil originated in the market for subprime mortgage-backed securities, much attention is currently directed at the flaws of the securitization process and particularly at the failures of the rating agencies (CRAs), which played a key role in this process. . . ."); FRANK PARTNOY, OVERDEPENDENCE ON CREDIT RATINGS WAS A PRIMARY CAUSE OF THE CRISIS 1 (2009) (presented at Eleventh Annual International Banking Conference) ("A primary cause of the recent credit market turmoil was overdependence on credit ratings and credit ratings agencies. Without such overdependence, the complex financial instruments, particularly collateralized debt obligations (CDOs) and structured investment vehicles (SIVs), which were at the center of the crisis could not, and would not, have been created or sold."), *available at* http://www.law.yale.edu/documents/pdf/cbl/Partnoy_Overdependence_Credit.pdf.

[31] For a more in-depth account of the ratings agencies, consider Frank Partnoy's many works on the ratings industry. *See, e.g.*, Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Ratings Agencies*, 77 WASH. U. L. Q. 619, 704—10 (1999) [hereinafter Partnoy, *Siskel and Ebert*]; Frank Partnoy, *How and Why Credit Ratings Agencies Are Not Like Other Gate-Keepers*, FIN. GATEKEEPERS 59, 64–68 (Yasuyuki Fuchita & Robert E. Litan eds., 2006).

[32] *See In re* Moody's Corp. Sec. Litig., 599 F. Supp. 2d 493 (S.D.N.Y. 2009).

[33] Teather, *supra* note 5. This Comment uses the term "NRSRO" to refer to the limited group of credit ratings agencies that qualify for the title.

[34] *See* Paul J. Davies et al., *Reputations to Restore; Rating Agencies Come Under Ever Closer Scrutiny*, FINANCIAL TIMES (London), July 22, 2008, at 11.

credit rating.[35] These ratings provide investors a barometer to evaluate the risk and probability of repayment of a security.[36] Investors are free to perform their own due diligence on most of the information available to the CRAs; however, the ratings agencies have access to some nonpublic information that gives them a distinct advantage.[37] The CRAs have carved out a space in the market as specialized intermediaries, assessing risk based on both public and nonpublic information.[38]

The agencies take in specific information and process it according to specific protocols;[39] this assembly-line feature of the ratings industry provides a solid shield against criminal liability. The analysts and executives can blame their own failures on the mechanics of their risk-models, and the standardized process offers a promising method of defeating the *mens rea* requirement.[40] But the agencies and their actors are not robotic creditworthiness machines; the ratings process is not purely a mechanical process in which XYZ input yields AAA output. There are humans at the wheel.

Standard & Poor's stipulates in its own materials that it will only give a credit rating "when there is adequate information available to form a credible opinion and only after applicable quantitative, qualitative, and legal analyses are performed."[41] The courts have recognized that agencies "are expected to look beyond the financial reports in assessing an issuer."[42] This

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[35] Bo Becker & Todd Milbourn, *How Did Increased Competition Affect Credit Ratings?* 11 (Harvard Business School, Working Paper 09-051, Sept. 15, 2010), *available at* http://www.hbs.edu/research/pdf/09-051.pdf.

[36] *Id.*

[37] *See* Jonathan R. Macey, *Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation*, 65 U. CHI. L. REV. 1487, 1500 (1998) (noting that "the only reason that rating agencies are able to charge fees at all is because the public has enough confidence in the integrity of these ratings to find them of value in evaluating the riskiness of investments").

[38] Becker & Melbourn, *supra* note 35, at 11–12.

[39] For example, before making a ratings decision, "S&P requires the following financial information from management [of an issuer], if possible: five years of audited financial statements; interim financial statements; operation and product descriptions; and draft registrations statements. In addition, non-public information may be presented confidentially to the rating agencies to help them arrive at an appropriate rating." *In re* HealthSouth Corp. Sec. Litig., 261 F.R.D. 616, 637–38 (N.D. Ala. 2009).

[40] *See infra* subpart III.A.

[41] STANDARD & POOR'S, STANDARD & POOR'S CORPORATE RATING CRITERIA 9 (2006), *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/corporateratings_052007.pdf.

[42] *In re* HealthSouth Corp. Sec. Litig., 261 F.R.D. at 637–38 (citing Cammer v. Bloom, 711 F. Supp. 1264 (D. N.J. 1989)) (relying on credit ratings in addition to the *Cammer* factors to evaluate the efficiency of the market for a security and determine on balance the viability of a class action claim under Sections 11 and 15 of the Securities Act and Sections

Comment argues that the fundamentally qualitative aspects of the ratings industry justify criminal liability when a ratings agency recklessly manipulates the qualitative inputs.[43]

B. CONFLICTS OF INTEREST AND OTHER ISSUES WITH THE RATINGS AGENCY MODEL

The credit ratings industry has taken substantial criticism as a system rife with perverse incentives and conflicts of interest.[44] The ratings agencies clearly failed leading up to the subprime collapse; as a result, scholars have scrutinized the CRAs' role in the market.[45] Professor John C. Coffee of Columbia Law School provided a useful, non-exhaustive list of the major issues afflicting the ratings industry to the Senate Committee on Banking, Housing, and Urban Affairs.[46] He identified five central problems: (1) the issuer-pays model, (2) the NRSROs' immunities from liability, (3) the licensing power of the NRSROs, (4) the oligopoly of only three ratings agencies, and (5) the weak incentive to update ratings.[47] Each of these issues raises doubts about the legitimacy of the current ratings system; considered together, they suggest that the industry needs complete reregulation and restructuring.[48]

A central concern that critics have with the existing system is the issuer-pays model.[49] Credit ratings agencies are paid by the issuers of

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10(b) and 20(a) of the Exchange Act). The court's use of credit ratings here demonstrates an institutional dependence on the ratings agencies so deep-rooted that the judiciary builds the ratings agencies into its factor-analysis of efficiency.

[43] S&P sets out some of the subjective criteria that go into a rating: "a thorough review of business fundamentals, including industry prospects for growth and vulnerability to technological change, labor unrest, or regulatory actions." STANDARD & POOR'S, *supra* note 41, at 9.

[44] *See, e.g.*, Arthur Levitt Jr., *Conflicts and the Credit Crunch*, WALL ST. J., Sept. 7, 2007, at A15; Serena Ng & Aaron Lucchetti, *Congress Takes on Credit Ratings—Ex-Moody's Analyst Says Inflated Ratings Continue*, WALL ST. J., Sept. 23, 2009, at C1, *available at* http://online.wsj.com/article/SB125366267173132295.html.

[45] *See, e.g.*, Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Ratings Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227 (2009).

[46] *Turmoil in U.S. Credit Markets: The Role of Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 70-72 (2008) (statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law at Columbia Univ. Sch. of Law), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-110shrg50399/pdf/CHRG-110shrg50399.pdf [hereinafter *Coffee Testimony*].

[47] *Id*. at 70–72.

[48] Partnoy, *supra* note 31, at 704.

[49] *E.g.*, Levitt Jr., *supra* note 44, at A15 ("[C]redit ratings agencies—such as Moody's Investor Service, S&P, and Fitch Ratings—are playing both coach and referee in the debt game. They rate companies and issuers that pay them for that service. And, in the case of

securities—an arrangement that immediately seems backwards because investors, not issuers, consume the ratings. The CRAs did not always structure their operations as pay-for-services; they used to generate revenue from subscriptions.[50] But in the 1970s, investor confidence plummeted in response to the unexpected bankruptcy of the Penn Central railroad; the issuers needed to assure investors that their debt instruments were still safe, low-risk assets, and issuers were willing to pay for those assurances.[51] The ratings agencies responded by abandoning John Moody's legacy of subscription service.[52] And thus began the issuer-pays model that has the "watchdog paid by the persons they are to watch."[53] Empirical research suggests that the fees charged to issuers amount to upwards of 90% of the CRAs' revenue.[54] Moreover, the CRAs are exacerbating this conflict of interest by offering pre-issuing consulting services to the issuers on top of the traditional rating services.[55] These consulting services are essentially trial runs that allow issuers to experiment and exploit the ratings models behind closed doors.[56] It also leaves the system vulnerable to criminal conspiracy; without transparency, actors at both an issuer and a ratings agency can cooperate to create an inflated rating—or even just an investment-grade rating—that generates revenue for both the issuer and the ratings agency.[57]

The next major issue is limited competition: the ratings industry is controlled by a triumvirate. Although the official group of NRSROs is no longer confined to the triumvirate, those three have solidified a position of superiority in the market. Even though federal regulations allow other

structured financial instruments which make it possible to securitize all those subprime mortgages, they help issuers construct these products to obtain the highest possible rating.").

[50] *See Credit Rating Agency Duopoly Relief Act of 2006*, 109 Cong. 2d Sess., Rpt. 109-546, 8 (2006) ("Originally the major rating agencies only received revenue from selling lists of their ratings to investors . . . [but] with the introduction of the copying machine, these ratings lists could be easily copied and disseminated; the agencies needed another source of revenue.").

[51] *See* Lawrence J. White, *The Credit Ratings Agencies: How Did We Get Here? Where Should We Go?* 8 (Fed. Trade Comm'n, Seminar Paper), *available at* http://www.ftc.gov/be/seminardocs/091112crediratingagencies.pdf.

[52] *Id.*

[53] *Coffee Testimony*, *supra* note 46, at 2.

[54] *See* Frank Partnoy, *How and Why Credit Ratings Agencies Are Not at All Like Other Gatekeepers* 62 (Univ. of San Diego Sch. Of Law, Legal Studies Research Series, Research Paper No. 07-46 2006), *available at* http://ssrn.com/abstract=900257.

[55] *See Coffee Testimony*, *supra* note 46, at 72.

[56] *Id.*

[57] *See* Lynch, *supra* note 45, at 247 ("Issuers want high ratings, not necessarily accurate ratings. The higher the securities rating, the less concern investors will have about payment default, the greater the liquidity, and the lower the issuers' cost of capital.").

ratings agencies to qualify as NRSROs, "[t]he federal government created the rating cartel, and the U.S. is as dependent on it as everyone else."[58] The history of ratings-agency legislation and regulation has resulted in a system that gives three agencies tremendous power.[59] From the standpoint of an investor, it seems obvious that such tremendous power should come with substantial accountability. A government-endorsed oligopoly should not be able systematically to mislead the entire investing public without risking criminal punishment.

The next issue raised by Professor Coffee—the CRAs' immunity from civil liability—has been at the heart of many proposals for regulatory reform.[60] The ratings agencies enjoy statutory privileges that insulate them from the kinds of investor lawsuits that regularly target issuers, banks, and other market players.[61] Furthermore, many courts continue to empower the agencies with a broadly construed First Amendment defense that treats the CRAs as publishers of constitutionally-protected opinions.[62] When issuers

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[58] *See* David Evans & Caroline Salas, *Flawed Credit Ratings Agencies Reap Profits as Regulators Fail Investors*, BLOOMBERG NEWS, Apr. 29, 2009, *available at* http://www.bloomberg.com/apps/news?pid=20601101&sid=a6NdKd8CfR2A.

[59] Congress has had opportunities to reconsider the structure of the ratings market and proactively open the market to competition. For whatever reason, these opportunities have not done much to bust up the ratings triumvirate. One potential competitor has argued that the political discourse itself is dominated by the existing powers. For example, in 2002, when Congress addressed the ratings market after the Enron disaster, the Egan & Jones agency lodged the following complaint:

> We do not believe that investors' interests are adequately represented in the composition of the Hearings on Credit Ratings Agencies or that there will be any meaningful change in the non-independent partner monopoly that is the root cause of the failure to warn investors. The majority of the panel is comprised of the current NRSRO's, large security firms, large issuers, large investors (which are capable of doing their own research), associations representing large security firms (the SIA and Bond Market Association) and issuers (the Association for Finance Professionals) and large investors (the Investment Company Institute). One of the two academics included is conflicted (Schwarcz's research center is supported by S&P and the large security firms).
>
> Conspicuously absent are independent academics who are considered experts in the field such as Larry White of NYU and Frank Partnoy of Washington University, consumer and investor advocates such as the Consumer Federation of America, the Department of Justice and groups that have been hurt by the WorldCom, Enron, Global Crossing and other failures.

Letter from Sean J. Egan & W. Bruce Jones, *Letter Re: Hearing on Credit Ratings Agencies* Egan-Jones Rating Company, to Jonathan G. Katz, Secretary, U.S. Sec. & Exch. Comm'n (Nov. 10, 2002), *available at* http://www.sec.gov/news/extra/credrate/eganjones2.htm.

[60] *See, e.g.*, Fact Sheet, U.S. Sec. and Exch. Comm'n, Strengthening Oversight of Credit ratings agencies, Open Meeting of the Securities and Exchange Commission, Sept. 17, 2009, *available at* http://www.sec.gov/news/press/2009/2009-200-factsheet.htm.

[61] *Coffee Testimony*, *supra* note 46, at 71.

[62] *See* Cnty. of Orange v. McGraw Hill Co., Inc., 245 B.R. 151 (C.D. Cal. 1999) (holding that ratings are covered by the First Amendment); *see also* Evans & Salas, *supra* note 58

attempt to bring suit under a theory of defamation, the issuers "must show that the rating agencies relied on falsehoods because of actual malice and had actual knowledge or reckless disregard for the truth or falsity of their claims."[63] The First Amendment has largely insulated the CRAs from civil liability to issuers. The CRAs operate with remarkably little risk of liability given how high the stakes of their actions can be.[64] "Put simply, if credit ratings agencies do not have to fear liability to investors, they have less incentive to be diligent or prudent."[65] Although there is a strong case for expanded civil liability, the criminal provisions this Comment recommends would provide a more effective solution without the risks of burdensome, inefficient investor lawsuits.[66] The state, not investors, should police the ratings agencies.

The next issue that Coffee identified—the CRAs' regulatory licensing function—focuses on how credit ratings have become mandatory for certain actions by institutional investors.[67] From this perspective, the ratings agencies "have thrived, profited, and become exceedingly powerful because they have begun selling regulatory licenses, i.e., the right to be in compliance with regulation."[68] The issues raised by this regulatory licensing view amplify some of the aforementioned problems. In particular, from this perspective we can see the irrationalities and dangers of an issuer-

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("The U.S. District Court in Santa Ana, California, ruled that the county would have needed to prove the rating company's 'knowledge of falsity or reckless disregard for the truth' to win damages.").

[63] Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1055 (2009) ("This First Amendment hurdle has made it extraordinarily difficult to establish that rating agencies engaged in libel and has left issuers without legal recourse except in outlier cases."); *see also* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1688–92 (2008) (discussing how 2006 legislation failed to address the almost complete immunity that the CRAs enjoy from tort liability).

[64] *See* STAFF OF S. COMM. ON GOV'T AFFAIRS, 107TH CONGRESS, FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 82 (Comm. Print 2002), *available at* http://hsgac.senate.gov/100702watchdogsreport.pdf ("SEC Rule 436, promulgated under the Securities Act, expressly shields NRSROs from liability under Section 11 of the Securities Act in connection with an offering of securities. This means that NRSROs are not held even to a negligence standard of care for their work."); Jonathan S. Sack & Stephen M. Juris, *Rating Agencies: Civil Liability Past and Future*, 233 N.Y. L. J. 88, Nov. 5, 2007 ("Despite the concerns reflected in this new legislation, NRSROs are largely insulated from liability. Notably, NRSROs are shielded from potential liability under § 11 of the Securities Act of 1933, which otherwise imposes strict civil liability on underwriters, accountants, and others for materially false registration statements.").

[65] *Coffee Testimony*, *supra* note 46, at 71.

[66] *See infra* subpart III.B.

[67] *Coffee Testimony*, *supra* note 46, at 71.

[68] *See* Partnoy, *Siskel and Ebert*, *supra* note 31, at 711.

pays model.[69] Civil penalties are not a sufficient disincentive against falsified ratings. If the issuer-pays model is to have any coherence, there needs to be a powerful set of disincentives that caution against conspiratorial misconduct between issuers, institutional investors, and the CRAs. This Comment suggests that a stronger criminal law would have the capacity to increase stability if the issuer-pays model survives.

The last major problem is the lack of incentives to update ratings.[70] This issue feeds back into many of the others. For instance, it highlights the flaws of an issuer-pays model: issuers obviously have no incentive to push for an update when it will result in a downgrade; moreover, the CRAs do not collect fees for updates so they have no financial incentive to be diligent.[71] These issues compounded to create the flawed ratings system that precipitated the credit crisis. As these issues are explored in the context of regulatory reform, it is hard to envision a civil regulatory regime that can adequately address the problems of the existing system. Criminal provisions, unlike complex civil regulations, could provide an overarching disincentive structure that addresses the issues without burdening the system with the unpopular expense of civil regulatory compliance.[72]

C. THE RISE OF COMPLEX STRUCTURED FINANCE AND THE RATINGS AGENCIES' FAILURE TO ADAPT

The previous two subparts have set out some of the structural weaknesses of the credit ratings industry. This subpart describes how the rapid growth of structured finance exploited and exposed those weaknesses, ultimately contributing to the subprime and credit crises.[73] The swift

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[69] When the issuers pay the ratings agencies and the issuers need certain ratings in order to sell their debt instruments, the ratings agencies are put under intense pressure by the issuers (their primary source of revenue) to provide the necessary rating. One interesting aspect of the CRAs' regulatory licensing function is that it runs counter to the theory that ratings are merely published opinions constitutionally protected under the First Amendment. If ratings were merely opinions, institutional investors would not give the ratings agencies a licensing power.

[70] *Coffee Testimony*, *supra* note 46, at 72.

[71] *Id*.

[72] *See, e.g.*, William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private,"* 55 EMORY L.J. 141, 142–44, 152 (2006) (describing how issuers will seek the system with the optimal amount of regulation and how Sarbanes-Oxley risks driving out companies because of the inefficiently high costs of compliance).

[73] It has been suggested that the very creation of these increasingly complex structured finance products might be enough to establish liability under some theory of fraud. *See* R. Christopher Whalen, Policy Brief, *The Subprime Crisis—Cause, Effect, and Consequences* 7 (Networks Fin. Inst., Working Paper, Mar. 2008), *available at* http://ssrn.com/abstract=1113888 ("CDOs and other types of OTC derivatives blossomed

expansion of the markets for residential-mortgage-backed securities and collateralized debt obligations (CDOs) led to a debt market full of new types of investment products with unknown risk-metrics.[74] Well before the financial meltdown, Warren Buffett referred to these new structured finance vehicles as "financial weapons of mass destruction."[75] CDOs are securities collateralized by a pool of asset-backed securities, for which the underlying collateral is primarily subprime residential mortgage loans.[76] Rating complex securities and CDOs requires more sophisticated risk models; yet the ratings agencies willingly rated these experimental, untested products as quickly as the issuers could package them.[77] The issuers were dependent on the ratings agencies because they needed a comprehensible risk-metric to successfully market these new investment products to investors.[78]

The details of the complex rating process for CDOs and asset-backed securities are beyond the scope of this Comment. However, it is worth noting the role of credit enhancements in the ratings process.[79] Credit enhancements are cushions that supposedly prevent cataclysmic losses even in the event of extraordinarily weak market conditions.[80] In determining the required level of credit enhancements, the ratings agencies supposedly assume "catastrophic losses on an order of magnitude of the Great Depression."[81] Credit enhancements are intended to function as a line of defense against particularly rough market conditions. When the subprime crisis hit, credit enhancements failed to serve this defensive role. Thus, the CRAs' failures cannot be explained away by extreme market conditions; the constricted market simply exposed the inadequate disincentives governing the ratings industry.

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into hideously complex and opaque permutations, configurations that a smart trial lawyer might successfully argue were deliberately deceptive.").

[74] *See id.* ("[T]he rapid acceleration of financial technology created classes of assets that neither the Federal Reserve nor the other regulators ever anticipated—or understand even today.").

[75] *Buffett Warns on Investment 'Time Bomb,'* BBC NEWS (Mar. 4, 2003, 1:32 PM), http://news.bbc.co.uk/2/hi/business/2817995.stm.

[76] *See* Merrill Lynch, Annual Report 2009 (Form 10-K), at 27.

[77] *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2047 (2007).

[78] *See generally* Bo Becker & Todd Milbourn, *How Did Increased Competition Affect Credit Ratings?* (Harv. Bus. Sch., Working Paper No. 09-051, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1278150##.

[79] *See* Engel & McCoy, *supra* note 77, at 2047.

[80] *See id.*

[81] *Id.*

D. EXISTING PROPOSALS FOR REFORM: A FOCUS ON AMENDING THE CIVIL REGULATORY SCHEME

In light of the ratings agencies' failures, most scholars agree that the "architecture of credit ratings agency regulation needs reform."[82] The proposals to date have focused on restructuring the civil regulatory regime.[83] They address important deficiencies in the incentives that currently control the ratings agencies including the conflicts of interest and the problems of a three-player ratings industry.[84] Some of these proposals could remedy many of the underlying issues with the ratings industry. By exploring these promising but incomplete solutions through civil reregulation, I hope to demonstrate how criminal provisions could fill some of the gaps and provide a more functional regulatory framework.

The important focus in both critiques and proposals for reform of the credit rating system is how the incentives operate. One theorist suggests addressing the perverse incentives of a reputational capital model of ratings agencies by replacing it with a profit-disgorgement model.[85] Briefly, the reputational capital model "holds that a well-functioning reputation mechanism will give ratings agencies optimum incentives for producing high-quality ratings."[86] Ratings agencies develop a reputation based on the quality and accuracy of the ratings they produce; thus, they have an incentive to bolster that reputation by producing good-quality ratings.[87]

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[82] Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* 7 (U. of San Diego Sch. of Law Legal Studies Research Paper Series, Research Paper No. 09-014, 2009), *available at* http://ssrn.com/abstract=1430608.

[83] Concept Release on Possible Rescission of Rule 436(b) Under the Securities Act of 1933, 74 Fed. Reg. 53,114 (proposed Oct. 15, 2009) (to be codified at 17 C.F.R. pt. 220) ("[W]e are now exploring whether Rule 436(g) is still appropriate in light of the growth and development of the credit rating industry and investors' use of credit ratings."); *see also* Press Release, U.S. Sec. & Exch. Comm'n, *Rules and Forms at Issue in Removal of References to NRSRO Credit Ratings*, (Sept. 17, 2009), *available at* http://www.sec.gov/news/press/2009/2009-200-rulesformsaffected.htm.

[84] *See, e.g.*, Norris, *supra* note 14, at C1 ("One clear improvement to the current structure of the debt markets would be to insist that all information shared with rating agencies be shared with the whole market.").

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

[86] *Id.* at 113.

[87] *Id.* ("The underlying idea is that if investors determine that a rating agency's ratings are of low quality, they will stop crediting the ratings, and the agency's business will lose value.").

But there are clearly problems with the reputational capital model. For example, it is not obvious that investors are sensitive to reputation.[88] In fall 2009, a Moody's analyst revealed that his employer gave a complex debt security a falsely inflated rating in January 2009, knowing full well that the underlying assets would be downgraded; as he predicted, the securities were put on review for downgrade shortly thereafter.[89] This occurred despite the already tarnished reputation of the ratings agencies. If actors at the ratings agencies are continuing to provide favorable ratings without serious concern for inaccuracies and downgrades, then the reputational capital model is not functioning as an adequate check on misconduct.

The profit-disgorgement model is an alternative whereby the CRAs would have to give back the fees they received for a rating if the rating turned out to be unreasonably inaccurate.[90] Although this proposal has some intellectual appeal, in practice it would almost certainly trigger expensive and inefficient conflicts between the issuers and the ratings agencies whenever things went awry. Litigation would arise over whether fault was with the issuer or the ratings agency for inaccuracies, and whether those inaccuracies were unreasonable. Adding systematic costs to the transactions between the ratings agencies and the issuers is not a cost-effective mechanism to protect investors.[91]

In September 2009, the SEC approved a series of proposals designed to strengthen oversight of CRAs, "enhance disclosure and improve the quality of credit ratings."[92] These proposals included new and improved disclosure requirements[93] and a more rigorous set of reporting requirements to ensure compliance with the SEC regulations.[94]

A preeminent scholar of the credit ratings industry, Frank Partnoy, suggests that "Congress should create a new Credit Rating Agency Oversight Board (CRAOB) with the power to regulate rating agency practices, including disclosure, conflicts of interest, and rating

[88] *See* Cantor, *supra* note 21, at 4 (noting that the reputational capital model is entrenched but can only function properly if investors are able to rely on the high quality of the CRAs' ratings).

[89] *See, e.g.*, Ng & Lucchetti, *supra* note 44.

[90] *See* Hunt, *supra* note 85, at 182–83.

[91] *But see id.* at 194–95 (suggesting that the profits would be disgorged to investors, ultimately restoring at least part of their losses). However, even if profits were disgorged to investors, the system costs of ongoing monitoring and regular litigation would be much more substantial than targeted criminal provisions that only resulted in the occasional high-profile suit.

[92] Fact Sheet, *supra* note 60.

[93] For example, it proposed substantially more disclosures about conflicts of interest. *See id.*

[94] *Id.*

methodologies, as well as the ability to coordinate the reduction of reliance on ratings."[95] Partnoy's theory is that the SEC is not currently in a position to provide the necessary oversight. However, he agrees that "Congress could enhance the authority of the SEC to grant it similar power to oversee the rating business."[96] Back in 1999, Partnoy recommended that we replace credit ratings with credit spreads.[97]

Some go so far as to propose the elimination of all regulation of the credit-rating industry.[98] The thrust of this free-market argument is that the reputational capital model will self-regulate the ratings industry and the government does not need to interfere with regulations. This radical theory mounts an attack both on the special treatment of NRSROs and the regulatory licensing function of the ratings agencies.[99] The proposal theorizes that "[i]f a rating agency, unprotected by a government oligopoly, issues lousy ratings, it's going to lose business."[100] Although this theory might have some appeal, it would be dangerous and radical, raising issues of system-wide deregulation well outside the scope of this Comment.

Many of these proposals for reform are persuasive, particularly those directly addressing the conflicts of interest in the current system. However, this Comment suggests that instead of a thorny web of civil regulations that are expensive from both a compliance and enforcement perspective, a narrowly tailored criminal law would deter the most problematic misconduct, restore investor trust in the markets, and ensure a much higher baseline standard of care. Before exploring that proposal, it is worth discussing the inadequacies of the existing criminal law.

III. DISCUSSION

Prosecutors have not been completely blind to the possibility of criminal suits against actors at the credit ratings agencies.[101] For example,

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[95] Partnoy, *supra* note 82, at 2.

[96] Partnoy, *Siskel and Ebert*, *supra* note 31, at 704–10.

[97] *See id*. Credit spreads are best understood as the difference in yield between U.S. federal government-issued debt securities and the subject private debt security. *See id.* at 704–09.

[98] *See, e.g.*, Michael Sisk, *A 'Radical' Answer to Credit-Ratings Conflict*, U.S. BANKER July 2008, at 48, *available at* http://www.americanbanker.com/usb_issues/118_7/-357008-1.html.

[99] *Id.*

[100] *Id.* ("The government should remove itself completely from the credit-rating business, stop deciding which company can and can't rate a bond, and stop making institutions pay attention to rating agencies whose work may be shoddy.").

[101] *See, e.g.*, Press Release, Connecticut Attorney General's Office, Attorney General Says His Broader Investigation into Credit Ratings Agencies Continuing Aggressively (June 5, 2008), *available at* http://www.ct.gov/AG/cwp/view.asp?A=2795&Q=416772 ("The

the California attorney general launched a broad investigation into the ratings agencies.[102] The goal of that investigation was to determine the CRAs' "role in fueling the financial crisis" by exploring whether they:

- Failed to conduct adequate due diligence in the rating process;
- Gave high ratings to particular securities when they knew or had reason to know that high ratings were not warranted;
- Failed to comply with their own codes of conduct in rating certain securities;
- Profited from giving inaccurate ratings to particular securities;
- Made fraudulent representations concerning the quality or independence of their ratings;
- Compromised their standards and safeguards for profits;
- Failed to use statistical models that captured the risk inherent in subprime and other risky assets; or
- Conspired with the companies whose products they rated to the detriment of investors.[103]

These questions set out a frame for possible criminal cases and provide a solid set of issues to consider in drafting a criminal statute targeting the ratings industry.[104] Former California Attorney General Edmund G. Brown is one of a handful with prosecutorial power who has explored the possibility of criminal suits. This hesitation to pursue criminal charges suggests that those with prosecutorial power do not think criminal convictions are likely.[105] Moreover, the driving force of the recent wave of litigation against the CRAs has been monetary recovery and not punishment.[106] There are a number of theories of criminal liability that a

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rating industry is highly concentrated, with three private, for-profit companies effectively controlling large swaths of our credit markets. As I recently urged Congress and the SEC, this fatally flawed system must be fixed. I proposed several specific reforms—reasonable, relatively simple steps that will go a long way toward making credit ratings more accurate and trustworthy. My investigation continues and may result in legal action.").

[102] Press Release, Office of the Attorney General, State of Cal. Dep't of Justice, Brown Launches Investigation into Credit Rating Agencies' Role in Fueling Financial Crisis (Sept. 17, 2009), *available at* http://ag.ca.gov/newsalerts/release.php?id=1808.

[103] *Id.*

[104] *See infra* notes 131–135 and accompanying text.

[105] *See* Ceresney, *supra* note 15, at 263 ("Rather than focus on past wrongdoing . . . [law enforcement agencies have] pushed for significant changes in the business practices of credit rating agencies, again avoiding the proof problems involved in proving criminal wrongdoing."). The dearth of lawsuits could also, however, suggest that those with prosecutorial power are simply exercising prosecutorial discretion in consideration of the time and expense required for these complex cases.

[106] *See, e.g.*, Liz Rappaport & Nathan Becker, *Ohio Files Suit Against Credit Raters*, WALL ST. J., Nov. 21, 2009, at B3 (describing a suit against the ratings agencies seeking recovery for massive losses to public pension funds).

prosecutor might consider under the existing law, but this Comment argues that these cases are weak at best, evincing the need for a targeted criminal law with some teeth to it.

A. CRIMINAL LIABILITY UNDER EXISTING LAW

A criminal prosecution against a CRA actor would be difficult on at least two major fronts: (1) causation and (2) *mens rea*. Prosecutors could try to bring a wire fraud case, a case for fraudulent violation of SEC regulations, or a more general criminal fraud case at the state level. In all cases, the theory of causation would be attenuated unless incriminating information came to the surface that conclusively correlated the ratings to investor decisions. The *mens rea* requirement would be the highest hurdle for fraud charges requiring knowledge or intent. The *mens rea* in a hypothetical prosecution against a CRA actor would be shrouded by (a) the complexity of these investment products and (b) market-wide risk-metric failures.

1. Causation

With civil suits moving forward against the CRAs, one might expect there to be a solid case for causation in the criminal context.[107] However, the causation issues in a criminal case against an individual actor would be different because a prosecutor would have to connect the individual defendants' actions to the harm. In the civil suits, the plaintiffs can target a ratings agency broadly and can triumph on securities fraud claims without establishing any misconduct by specific actors at the ratings agencies. However, a generalized causation argument that might succeed in a civil suit would not suffice for a criminal prosecution against an individual.[108] It would be difficult to prove that an individual actor at the CRAs took any action that in itself rose to the level of criminal fraud.

2. Mens Rea

The *mens rea* requirement would be a formidable hurdle under the existing law and probably explains the absence of any prosecutions.[109]

[107] *See, e.g.*, *In Re* Moody's Sec. Litig., 599 F.Supp.2d 393 (S.D.N.Y. 2009).

[108] *See* Henderson v. Kibble, 431 U.S. 145, 151 (1977) (holding that "the Constitution requires proof beyond a reasonable doubt of every fact necessary to constitute the crime," including causation).

[109] *See* Ceresney, *supra* note 15, at 228 (setting out the difficulty of establishing a *mens rea* as part of the reason for so few criminal cases in the subprime crisis).

Proving *mens rea* is a difficult task that is at the heart of the criminal law.[110] The difficulties of establishing *mens rea* are particularly burdensome in complicated fraud cases like those that would arise in the credit ratings market.[111] There are no obvious facts from which to establish *mens rea* in the ratings industry. Without initiating an investigation, there is nothing that CRA actors do or produce that would indicate knowledge or intent. One commentator explains:

> The assessments of accountants like Arthur Andersen can be tested. If an accountant doesn't follow GAAP, or Generally Accepted Accounting Principles, his negligence can be checked, and he can be cast out of the profession—or prosecuted. By contrast, ratings agencies, despite carrying the government's imprimatur, each have their own unique methods of rating. There is no standardized approach as there is in the accounting industry. "They are masters of their own methodologies. You have to prove their own methodologies are wrong. . . ."[112]

The ratings agency analysts and executives can defend a criminal charge by professing reliance on their ratings models. They can say that at worst they realized in hindsight that the models were inaccurate. There is nothing in the actions of a CRA analyst or executive in rating a debt instrument that would help establish *mens rea*, aside from any outright admission of knowledge or intent.

3. Theories of Liability

A theory of liability in a potential case against a CRA actor would fall under the umbrella of fraud.[113] A criminal prosecutor could try to develop the following general theory, varying somewhat by jurisdiction or based on the particular federal statute: criminal liability exists when (1) a ratings agency defendant (2) intended to defraud (3) by knowingly distributing false information, (4) expecting investors to rely on that false information, (5) which investors did rely on, (6) resulting in a loss to those investors.[114]

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[110] *E.g.*, Edwin R. Keedy, *Ignorance and Mistake in Criminal Law*, 22 HARV. L. REV. 75, 81 (1908) ("It is a fundamental principle of the criminal law, for which no authorities need be cited, that the doer of a criminal act shall not be punished unless he has a criminal mind.").

[111] *Cf.* Ceresney, *supra* note 15, at 228 ("Even in situations where there was wrongdoing, the time and resources required to mount investigations and the burden of proving intent to defraud are formidable obstacles for prosecutors and regulators to surmount, except in the most straightforward of fraud cases.").

[112] Michael Hirsh, *Drop Moody's into the Volcano*, NEWSWEEK, (Sept. 30, 2009), http://www.newsweek.com/id/216486 (quoting a former Moody's managing director).

[113] "Fraud" does not delineate a specific federal crime, but rather is a concept underlying a genus of crimes. *See* Ellen S. Podgor, *Criminal Fraud*, 48 AM. U. L. REV. 729, 731–34 (1999).

[114] This general construction does not derive from a particular statute or common law rule, but a synthesis of elements in various statutes. *Cf. id.* at 749–60.

The most difficult piece to prove in this general theory would be intent. A prosecutor would have to convince a jury not only that a defendant was recklessly endangering investors but also possessed an intent to defraud.

What charging offenses are available to prosecute fraud in these kinds of high-stakes cases? One specific statutory theory of fraud that prosecutors might advance would be wire fraud. The four elements of criminal wire fraud are the following: (1) the defendant voluntarily and intentionally devised or participated in a scheme to defraud another out of money, (2) the defendant did so with the intent to defraud, (3) it was reasonably foreseeable that interstate wire communications would be used, and (4) interstate wire communications were in fact used.[115] Here, like in the general theory, a prosecutor would need to demonstrate an intent to defraud. That high *mens rea* requirement protects the ratings agencies from federal prosecutors.

The closest thing to a targeted statutory criminal charge under the existing law would flow from the Credit Rating Agency Reform Act of 2006 (CRA Reform Act).[116] Although there is no criminal charge explicitly defined in the statute, it sets the groundwork for potential criminal or criminal conspiracy charges against the CRAs. The statute charges the SEC with regulating the ratings agencies, imposing specific requirements with respect to the conflicts of interest inherent in the ratings industry.[117]

The SEC has promulgated regulations, including SEC Rule 17g-5, which requires ratings agencies "to disclose and manage conflicts of interest that arise in the normal course of engaging in the business of issuing credit ratings."[118] This regulation opens the door to charges of criminal conspiracy, as explained in one report:

> [I]f the government can prove that some sort of tacit agreement existed between the investment banker and the credit ratings agency in which the banker would bring his deals to the rating agency in return for a good rating, the government is likely to argue

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[115] *See* United States v. Proffit, 49 F.3d 404, 406 (8th Cir. 1995). Sometimes courts parse the cause of action into a different number of elements but these different constructions all amount to the same general requirements. *See, e.g.*, United States v. Faulkner, 17 F.3d 745, 771 (5th Cir. 1994) (parsing wire fraud into two essential elements: (1) a scheme to defraud, and (2) the use of, or causing the use of, interstate wire communications to execute the scheme); United States v. Cassiere, 4 F.3d 1006, 1011 (1st Cir. 1993) (setting out the wire fraud elements as (1) a scheme to defraud by means of false pretenses, (2) defendant's knowing and willful participation in the scheme with intent to defraud, and (3) use of interstate wire communications in furtherance of the scheme).

[116] Pub. L. No. 109-291, 120 Stat. 1327 (codified at 15 U.S.C. § 78o-7 (2006)).

[117] *Id.*

[118] Press Release, SEC, SEC Votes to Adopt Final Rules to Implement the Credit Rating Agency Reform Act of 2006, May 23, 2007, *available at* http://www.sec.gov/news/press/2007/2007-104.htm.

> that it not only constitutes a conflict of interest but should be considered a criminal conspiracy.
>
> To prove a criminal conspiracy, the government need only prove the existence of an illegal act and an agreement to perform. This is arguably easier to prove than an aiding-and-abetting violation, which requires proof of both knowledge and substantial assistance, thus potentially exposing both the rating agencies and investment banks to additional criminal charges.[119]

In order to successfully bring a case under SEC Rule 17g-5, a prosecutor would have to prove that the CRA actor intentionally conspired to withhold disclosure of conflicts of interest. Some CRA agency executives have publicly admitted that conflicts at their agencies caused inaccuracies in the ratings: "Conflicts of interest were largely responsible for the disastrous performance of credit ratings agencies in assessing the risks of mortgage-backed securities, two former high-ranking officials at Moody's Investors Service and Standard & Poor's said . . . in Congressional testimony."[120]

This admission would seem to bode well for a criminal case against the ratings agency executives. Unfortunately, the admission is not as substantial as it seems at first blush. The CRA executives have only admitted in hindsight that they realize how the conflicts of interest caused ratings agency failures. In order to establish the *mens rea* for criminal conspiracy, a prosecutor would need to show that the defendants had the *mens rea at the time* the alleged CRA misconduct occurred.

What about those analysts who sent what looked like smoking-gun emails back and forth about the ratings agency system being a well-constructed house of cards?[121] Standing alone, those emails seem to impute a *mens rea* of at least knowledge with respect to the ratings agencies' false disclosures. What is stopping these emails from at least getting a criminal case before a jury? The attenuated causal connection between the emails and the harm makes the case against these analysts weak at best. The CRA Reform Act does not place a positive duty on all ratings agency actors to disclose their knowledge of conflicts of interest.[122] There is no Good Samaritan law that imposes criminal sanctions for failing to report the misconduct of others. Thus, unless the analysts intended to act in furtherance of a fraud crime, they cannot be held liable for complicity or

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[119] WILLIAM R. "BILLY" MARTIN, ET AL., THE SUBPRIME MORTGAGE CRISIS: SOMEBODY HAS TO PAY 4 (2009), *available at* http://www.sutherland.com/files/News/8d710730-7bb5-4ee0-88d0-84d1bed596fe/Presentation/NewsAttachment/2eaf4704-0967-459e-a838-40219a20068f/Reprint_Martin.pdf.

[120] Gretchen Morgenson, *Credit Ratings Agency Heads Grilled by Lawmakers*, N.Y. TIMES, Oct. 22, 2008, at B1.

[121] *See* Taylor, *supra* note 1.

[122] *See* 15 U.S.C. § 78o-7 (2006) (placing no affirmative duty on the CRAs).

conspiracy. Prosecutors seem to have no solid case against any actor at the ratings agencies, despite institutional knowledge that false and misleading ratings were placing unjustifiable risks on investors. The absence of a viable criminal case fails to capture the magnitude of harm caused by the CRAs and the central importance of credit ratings to investors.

4. Mistake of Fact Defense and Other Hurdles

Another hurdle that a prosecutor faces is a mistake of fact defense.[123] Mistake of fact allows a defendant to defeat a charge if he honestly believed in a set of facts that would prevent him from forming the requisite *mens rea* required to constitute the crime.[124] An agency analyst would be able to argue that he honestly believed the ratings models were functional or that the ratings were reasonably accurate, which would defeat the requisite *mens rea* of knowledge or intent required for a fraud crime under the existing law. The CRAs could also argue that they were ignorant of undisclosed, material information from the issuers.[125]

Another issue is willful blindness. The ratings agencies can probably survive a criminal prosecution even if there is a showing of willful blindness. Unlike public companies, the CRAs are immune from the disclosure requirements of the Sarbanes-Oxley Act of 2002 (SOX).[126] SOX put in place a much stronger set of criminal disincentives for corporate executives;[127] however, those laws do not cover the ratings agencies.[128]

By no means is this an exhaustive review of the theories of liability, strategies, or defenses that would arise in a criminal case against a CRA defendant; however, the foregoing analysis will likely apply similarly to other charges.[129] More importantly, these issues demonstrate the substantial difficulty that prosecutors face in bringing criminal suits.

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[123] Mistake of fact is a longstanding doctrine that allows defendants to defeat liability by arguing subjective misapprehension of a material fact. *See generally* Keedy, *supra* note 110, at 81–88.

[124] *See* MODEL PENAL CODE § 2.04 (1985).

[125] *See* Keedy, *supra* note 110, at 81 ("One who commits a criminal act under mistake of fact has a defense, because he has wrong or insufficient data for reasoning.").

[126] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

[127] Michael D. Silberfarb, *Justifying Punishment for White-Collar Crime: A Utilitarian and Retributive Analysis of the Sarbanes-Oxley Act*, 13 B.U. PUB. INT. L.J. 95, 98 (2004).

[128] *See* Sarbanes-Oxley Act of 2002 tit. VII (expanding white-collar criminal law and increasing sentences, but targeting corporate actors without including CRA actors).

[129] For instance, there could be charges of intentional misstatements or omissions, which can constitute federal criminal violations under 18 U.S.C. § 1001 (2006). The *mens rea* required for a conviction under this statute is still intent.

B. PROPOSED SOLUTION: A NARROWLY TAILORED CRIMINAL LAW ADDRESSING THE ISSUES AFFLICTING THE RATING INDUSTRY

Congress should consider enacting new criminal provisions controlling the ratings agencies. There will undoubtedly be substantial opposition from the CRAs themselves and probably some issuers who have been colluding with the agencies. But Congress should find support from securitizers, investors, regulators, and the public. The packagers of investment products will be able to market their products more vigorously based on their ratings, which will be substantially more meaningful if the CRAs face significant criminal disincentives. Moreover, the risk of investor lawsuits will decrease if issuers, trustees, and investment managers can point to the ratings as a more reliable measure of risk. Investors will benefit in two ways from criminal regulation of the CRAs: (1) they will have more confidence in the ratings because they know the stakes are higher for analysts and executives at the CRAs and (2) they will have the opportunity to push for retributive justice if future misconduct causes losses.

The criminal CRA provisions could be part of a freestanding criminal statute or integrated with a civil regulatory statute like SOX.[130] The statute could build off of the following proposed core provisions:

> Title I—Credit Ratings Accountability
>
> § 1.01—Management Accountability
>
> (1) All credit ratings provided by a Nationally Recognized Statistical Rating Organization must be approved by two personnel, including at least one management-level individual.
>
> (2) Nationally Recognized Statistical Rating Organizations must keep records of which personnel certified each credit rating for a period not less than 10 years.
>
> Title II—Criminal Credit Rating Fraud
>
> § 2.01 Criminal Credit Rating Fraud
>
> Whoever recklessly certifies, or attempts to certify a falsely inflated or falsely depressed credit rating to be published by a Nationally Recognized Statistical Rating Organization shall be criminally fined or imprisoned not more than 15 years,[131] or both.

These provisions provide a basic skeleton with two important features. First, the requisite *mens rea* is expressly articulated as recklessness, which

[130] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codifying both civil and criminal provisions in various sections of 15 and 28 U.S.C.).

[131] A growing literature focusing on proportionality of sentences highlights the importance of legislative limits on sentences. *See, e.g.*, Richard S. Frase, *Punishment Purposes*, 58 STAN. L. REV. 67, 73 (2005).

will help solve the proof problem that prosecutors face.[132] The lower threshold of *mens rea* should incentivize more prosecutors to at least investigate the ratings agencies. The second important feature is the dual-certification requirement; this requirement will force management at the CRAs to take accountability for ratings along with analysts. It should provide a disincentive to management-level misconduct that counterbalances the existing conflicts of interest and financial incentives to inflate ratings.[133] As a result, all published ratings will carry a signature, comparable to an executive's signature on an SEC filing.[134]

This criminal law is narrowly tailored to exclusively cover NRSRO actions, because the ratings agencies serve a unique role in the markets. Congress should not lump the ratings agencies into the same statutory regime as issuers, banks, trustees, investment companies, and other players in the financial sector. The news media chose a narrative of the financial crisis that demonized "Wall Street" as though there were a unified mob of villains that walked the streets of Manhattan. A broad criminal statute would not adequately address the issues unique to the ratings industry: the ratings industry needs a narrow but robust set of criminal disincentives in place.

The complete provisions should flesh out the proposed frame and set out what types of quantitative and qualitative information a ratings agency must consider before rating a debt instrument. However, these requirements should not serve as a closed set of inputs for credit ratings. Overregulation would stifle innovation in both the ratings industry and the financial sector, while undermining the functioning of a competitive ratings market. The value of a credit rating continues to depend on the reputational capital of the ratings agency that issued it. If a ratings agency's risk-models were effectively government-controlled, investors would not be able to differentiate between the different ratings agencies. Furthermore, a fixed

[132] *Cf.* Ceresney, *supra* note 15, at 252 (arguing that there is already enough evidence for prosecutors to meet a knowledge or intent requirement).

[133] *Cf.* Lynch, *supra* note 45, at 254 ("[A] recent SEC report concluded that although analysts' salaries at the three largest NRSROs were generally based on seniority and experience, bonuses were based on individual performance *and* the overall success of the firm. The more business a credit rating agency solicits, the more successful and profitable it becomes.") (citations omitted).

[134] Courts have been resistant to imputing scienter from a signature. *See In re* Ceridian Corp. Sec. Litig., 542 F.3d 240, 248 (8th Cir. 2008) (rejecting the possibility that an executive's signature could be sufficient to establish scienter by asserting that "[a]llegations that accounting errors were discovered months and years later do not give rise to a strong inference that the certifications were knowingly false when made"). However, this Comment proposes a *mens rea* of recklessness for CRA criminality, which is lower than scienter. The signature would at least be strong evidence of the required mental state when taken in conjunction with gross inaccuracy of a credit rating.

set of inputs might not be able to capture the risks of new debt instruments, like the structured investment vehicles and CDOs that were at the heart of the subprime and credit crises.

Instead, the provisions should provide a baseline or core set of requirements from which analysts can construct risk-models within the statutory framework. The proposed criminal offense will specifically target and control these risk analytics. The ratings agencies should be held to a standard of conduct that represents their paramount importance in disseminating widely consumed evaluative information.

These criminal provisions will provide systematic legitimacy to the ratings industry, which in turn will bolster the whole financial sector. The implementation and enforcement of strict criminal sanctions for misconduct at the CRAs will restore investor trust. Investor confidence is crucial to economic recovery and market stability going forward.[135] Furthermore, as the financial sector begins to regain its footing, it will begin to innovate again, which could reintroduce the risks of untested new investment products. In order for this innovation to succeed, investors will need to rely on the ratings agencies to perform their role as gatekeepers.[136] These proposed criminal provisions would help stimulate economic growth by promoting investor confidence. Although a strict new civil regulatory framework could provide some of the same deterrent value, compliance and enforcement would be expensive and burdensome. Criminal disincentives provide powerful disincentives for wrongdoing without the expense of regulatory compliance.

C. JUSTIFICATIONS FOR PUNISHMENT

Under the existing law, a criminal conviction would be an expensive long shot. Neither the foregoing theoretical analysis[137] nor the empirical evidence (the absence of any successful prosecutions)[138] supports bringing

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[135] *See* Raymond H. Brescia, *Trust in the Shadows: Law, Behavior, and Financial Re-regulation*, 57 BUFF. L. REV. 1361, 1363 (2009) ("Trust acts as a lubricant and reduces the transaction costs associated with economic conduct; its presence makes economic activity more efficient and permits actors to focus on wealth generation rather than wealth preservation.").

[136] *See* Lynch, *supra* note 45, at 304 ("In a world of increasing complexity and opacity, investors may find it increasingly difficult to engage in their own risk assessments, and, even if they could do so, for all of them to do so would be increasingly inefficient. Rather, investors may continue to rely on rating agencies, financial analysts, and other informational proxies to provide reliable information about the risks and values of securities. . . .").

[137] *See supra* subpart III.A.

[138] *See, e.g.*, Ceresney, *supra* note 15, at 263–67 (noting that state securities regulators have focused on prospective civil reregulation but avoided pursuing criminal cases for past abuses).

criminal charges against actors at the ratings agencies. But does that mean criminal liability *should not* be imposed? Is the criminal law too forgiving? Or did the misconduct at the ratings agencies simply not rise to the level of criminality? Answering these questions requires an exploration of the normative theories of punishment. Most justifications for punishment fall into one of two camps: retribution and utilitarianism.[139] Both of those theories support criminal punishment of misconduct at the ratings agencies.

But is criminal punishment of ratings agency misconduct the *best* solution for the credit markets? Some scholars, particularly optimal penalty theorists,[140] would probably contest the value of incarceration for this kind of wrongdoing.[141] However, given the tremendous risks associated with ratings agencies' actions and the heated public outcry at their failures, incarceration would at the very least provide some cathartic value above and beyond monetary fines or civil compensatory and punitive damages.

1. Retributive Justice

The magnitude of harm that can result from wrongdoing at the ratings agencies should make criminal punishment a just desert for wrongdoers. Retribution is a theory of punishment that appeals to "the idea that punishment is directed at imposing merited harm upon the criminal for his wrong."[142] Under a retributive theory of punishment, putting a ratings agency actor on trial and imposing criminal punishment should only happen if that punishment, in and of itself, is warranted.[143] One of the many frustrations of the financial crisis has been a lack of accountability. From this standpoint, punishing the ratings agencies for misconduct that caused catastrophic losses seems to fill the void. The markets themselves have not

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[139] *See generally* JOSHUA DRESSLER, UNDERSTANDING CRIMINAL LAW § 2.03[A] (3d ed. 2001).

[140] Optimal penalty theory was introduced by Gary Becker and postulates that the criminal law should seek to deter illegal behavior in the most efficient way. *See* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 207–09 (1968).

[141] *See, e.g.*, Richard A. Posner, *Optimal Sentences for White-Collar Criminals*, 17 AM. CRIM. L. REV. 409, 410 (1980) (advocating for fines instead of imprisonment in many white-collar cases); Christopher A. Wray, Note, *Corporate Probation Under the New Organizational Sentencing Guidelines*, 101 YALE L. J. 2017, 2019–20 (1992).

[142] Michele Cotton, *Back with a Vengeance: The Resilience of Retribution as an Articulated Purpose of Criminal Punishment*, 37 AM. CRIM. L. REV. 1313, 1315 (2000); *see also* Leo M. Romero, *Punitive Damages, Criminal Punishment, and Proportionality: The Importance of Legislative Limits*, 41 CONN. L. REV. 109, 120 (2008) ("Retribution justifies punishment because it is deserved due to wrongful conduct.").

[143] *See* Lord Patrick Devlin, *Morals and the Criminal Law*, *in* THE PHILOSOPHY OF LAW 66 (Ronald M. Dworkin ed., 1977) (discussing how retribution is justified as an embodiment of the public perception of moral accountability).

inflicted damage on the CRAs: "Despite warnings from industry Jeremiahs and calls for change from Washington, Wall Street is betting the ratings services will avoid the radical reforms their most ardent critics are urging. The industry, the thinking goes, will remain much as it was before: protected, profitable and, detractors say, rife with conflicts."[144]

If the ratings agencies continue to profit without suffering any public penalties, there will remain a wound in the public consciousness, one that might heal if the ratings agencies are punished.

After Enron and other massive corporate scandals of the early 2000s, the government pushed for sweeping regulatory reform. Although the CRAs were investigated, they "were a low priority after the banks, accountancy firms and officers of the companies where fraud [had] been uncovered."[145] This time, the ratings agencies cannot hide behind Kenneth Lay or Charles Keating.

2. Specific Deterrence

If any individual actor in the credit ratings market spent time in jail, the threat of further punishment would promote honest behavior and specifically deter future fraud. Specific deterrence is a utilitarian theory of punishment grounded in preventing repeat offenses by the same individual.[146] Targeted criminal provisions would deter future misconduct by the CRA actors who played a role in the current crisis. A federal criminal statute would vastly reduce the risk of CRA actors engaging in the same kind of questionably fraudulent activity that precipitated or at least amplified the credit crisis. The threat of jail time is a powerful disincentive to all individuals, including the affluent, because it deprives citizens of their liberties.[147] Undoubtedly, actors at the ratings agencies would quickly become aware of new criminal provisions, and it would not take a discerning eye to determine the intent of those provisions. Thus, the enactment of a criminal statute governing the ratings agencies would provide specific deterrence almost immediately.

Congress could incorporate language into the statute that makes it clear the new laws are intended to deter the kind of misconduct that precipitated the credit crisis. Courts almost always interpret statutory laws

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144 David Gillin, *In Rating Agencies, Investors Still Trust,* N.Y. TIMES, June 4, 2009, at B1.

145 Teather, *supra* note 5.

146 *See generally* JOSHUA DRESSLER, UNDERSTANDING CRIMINAL LAW 10 (2d ed. 1997).

147 *See, e.g.*, Ernest Van Den Haag, *The Criminal Law as a Threat System*, 73 J. CRIM. L. & CRIMINOLOGY 769, 770–72 (1982) (addressing social scientists' challenges to the theory that punishment deters future misconduct by declaring that "the deterrent effectiveness of threats per se can hardly be questioned").

as only prospectively applicable.[148] Moreover, the Constitution prohibits ex post facto laws—laws that criminalize conduct prior to the enactment of the law.[149] Thus, a federal criminal law would not open the floodgates for prosecutors to go after past misconduct. However, if Congress articulated its intent to specifically proscribe the kind of conduct that the CRAs engaged in during the credit crisis, the statute would effectively put the CRAs on notice. The ratings agencies would need to adapt their practices and procedures to avoid criminal liability.

3. General Deterrence

There should be stricter criminal provisions in the credit ratings market because the threat of criminal sanctions is a powerful deterrent to white-collar actors.[150] General deterrence is a utilitarian theory that hypothesizes that punishment prevents future crimes on a system-wide basis.[151] Criminal punishment sends a clear message: our society will not tolerate a specific kind of misconduct.[152] The power of that message provides a justification for punishment as general deterrence.[153] General deterrence is particularly potent in high-profile criminal cases. As one journalist put it: "[H]igh-profile prosecution deters white-collar crime. White-collar criminals have a much larger stake in society and are therefore tractable. They see ex-Tyco

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[148] Cass R. Sunstein, *Justice Breyer's Democratic Pragmatism*, 115 YALE L.J. 1719, 1736 (2006) ("Because retroactivity is disfavored in the law, statutes will be construed to apply prospectively unless Congress has specifically said otherwise.") (citation omitted).

[149] *See* U.S. CONST. art. I, § 9, cl. 3 ("No Bill of Attainder or ex post facto Law shall be passed.").

[150] Although some argue criminal fines are

> perhaps the most efficient and effective means of deterring corporate crime and expressing society's condemnation . . . Congress must supplement these fines with other forms of punishment [or else] potential offenders will view the fines as a mere tax. . . . [I]n order to contribute to a change in corporate culture, the punishment must indicate society's condemnation and a mere tax would not perform this function.

Silberfarb, *supra* note 127, at 102–03 (citations omitted).

[151] *See* Johannes Andenaes, *The General Preventative Effects of Punishment*, 114 U. PA. L. REV. 949, 949–51 (1966); *see also* John Hasnas, *The Centenary of a Mistake: One Hundred Years of Corporate Criminal Liability*, 46 AM. CRIM. L. REV. 1329, 1336 (2009) ("[One] school of thought argues that the purpose of punishment is deterrence, which involves inflicting an evil on a wrongdoer to discourage others from committing similar wrongful acts.").

[152] *See* Andenaes, *supra* note 151, at 950.

[153] *See* DRESSLER, *supra* note 139, at § 2.03[B] (noting that from the perspective of general deterrence the goal is "to convince the general community to forego criminal conduct in the future"). In regulating the credit ratings market, this goal is slightly narrower: to convince the community of actors involved in the ratings process—issuers, CRAs, et al.—to forego wrongdoing in the future. *Cf. id*.

CEO Dennis Kozlowski rotting away in Sing Sing, and they don't want to be like him."[154]

In theory, there has been a trend towards tougher sentencing guidelines and less lenient criminal punishment of white-collar criminals.[155] In many areas of white-collar crime, the number of federal suits has dropped substantially in recent years, which might indicate that the more draconian sentencing guidelines are successfully deterring white-collar crime.[156] It could also indicate that (1) white-collar criminals have adapted their misconduct to evade criminal violations, (2) prosecutors have intentionally or arbitrarily decided to bring fewer white-collar cases, or (3) despite the harsh sentencing guidelines, the substantive law is too soft on white-collar crime.

In the case of the ratings agencies, the second possibility is unlikely because prosecutors have actively investigated the CRAs.[157] Both the first and the third possibilities suggest that Congress should seriously consider restructuring the substantive criminal law governing the ratings agencies. The ratings agencies could very well have adapted their behavior to exploit the weak criminal law. Regardless of whether the CRAs have knowingly circumvented the law, the law itself is far too soft. The ratings agencies wield huge amounts of power in credit markets—if anything, the law should be overly protective of investors.

Creating a clear set of criminal provisions targeted at the CRAs will strengthen the entire market for debt products and deter misconduct throughout the financial sector. If actors at the ratings agencies are wary of the risks of criminal liability, they will project that awareness when interacting with issuers, investors, and others in the market. This infectious vigilance will foster a heightened respect for the looming fist of the law and promote rigorous compliance. Although the risk of civil liability can also generally deter misconduct, the possibility of losing one's liberty provides an incentive on an entirely different order of magnitude.

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[154] Jesse Eisinger, *Making Sense of the Credit Debacle*, SLATE MAG. (Mar. 3, 2009 11:36 AM), http://www.slate.com/id/2212480/entry/2212685/.

[155] *See, e.g.*, Stephen Breyer, *The Federal Sentencing Guidelines and the Key Compromises upon Which They Rest*, 17 HOFSTRA L. REV. 1, 21–25 (1988) (noting the penalty increases for white-collar offenders).

[156] The number of federal criminal suits for securities and exchange fraud in 2008 was actually 35% *lower* than the number in 2005. *See* David Z. Seide & Brian M. White, *Don't Give Agencies Criminal Power—Consolidating Criminal and Civil Authority Is an Extreme Departure and Is Bound to Create More Problems*, NAT'L L.J., (June 8, 2009), http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202431252200&slreturn=1&hbxlogin=1 ("There were only 66 federal criminal cases brought for securities and exchange fraud in 2008, down from 101 cases in 2005.").

[157] *See, e.g.*, Press Release, *supra* note 101.

4. The Trend Toward Stricter White-Collar Criminal Law

When the Enron scandal came to light in 2001, it catalyzed a movement to clean up corporate behavior that led to a number of systematic changes.[158] One of those changes was an increase in prison sentences for white-collar crimes.[159] The United States Sentencing Commission overhauled the Federal Sentencing Guidelines, targeting white-collar crime.[160] The sentences for fraud-related white-collar crimes increased substantially both on paper and in practice.[161] This development was embraced by the investing public as a recognition "that white collar crimes pose a threat to the country's social and economic fabric as significant as that of organized crime and narcotics trafficking."[162]

The Enron debacle justified a stricter and harsher criminal law controlling the boardrooms of public companies.[163] Similarly, the credit crisis justifies a more exacting and forceful criminal law controlling the ratings agencies. Congress has already attempted to reregulate the civil liability system in the credit ratings industry to no avail.[164] The credit crisis showcased investors' vulnerabilities. As investment products become increasingly sophisticated, investors become increasingly reliant on the

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[158] John Kroger describes six major positive developments triggered by the Enron disaster: (1) increased prison sentences for white-collar crime, (2) formation of the Public Company Accounting Oversight Board, (3) a new bar on auditing companies providing consulting services, (4) stricter rules governing Special Purpose Entities, (5) efforts to reduce conflicts of interests, and (6) more resources for the SEC. *See* John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 114–19 (2005).

[159] *See* Frank O. Bowman, III, *The 2001 Federal Economic Crime Sentencing Reforms: An Analysis and Legislative History*, 35 IND. L. REV. 5, 7 (2001) (describing how the revised Federal Sentencing Guidelines post-Enron increased penalties for many white-collar crimes).

[160] *See* Kroger, *supra* note 158, at 115.

[161] *Id.* at 115 n.272.

[162] *Id.* at 115.

[163] Although SOX has been subject to critical commentary, most of the criticism focuses on the expensive and complicated civil regulations. *See, e.g.*, Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. ON REG. 229, 239–51 (2009) (discussing the pushback caused by the vast and sometimes crippling expense of SOX compliance). This Comment is not suggesting a complex civil regulatory framework for the CRAs; on the contrary, this Comment suggests tailored criminal provisions could provide more powerful disincentives than a complicated set of civil regulations.

[164] *See* Ceresney, *supra* note 15, at 265 ("Despite [post-Enron] reforms, similar criticism of ratings agencies has emerged during the current credit crisis, which superheated in July 2007, when the largest agencies announced plans to downgrade hundreds of bonds backed by subprime residential mortgages. . . . The ratings downgrades spooked an already nervous market, as investors fled stocks and low-quality bonds.").

ratings agencies to analyze credit risk.[165] When those ratings proved hollow promises of stability, investors rightfully expressed discontent at the state of the credit ratings system.[166] The stakes are too high to allow the ratings agencies to operate without a powerful disincentive scheme. Civil liability has proved an inadequate disincentive. The most effective disincentive scheme would include targeted criminal provisions that (1) deter wrongdoing and (2) justifiably punish high-risk misconduct.

5. Overcriminalization Concerns Should Not Affect Regulation of White-Collar Crime

The overarching goal of this Comment is to recommend a targeted expansion of the federal criminal law that deters misconduct at the ratings agencies. This Comment would be remiss not to address a body of scholarly literature in recent years describing a perceived problem: overcriminalization.[167] This Comment admittedly encourages Congress to consider an increase in criminalization in the ratings market. However, overcriminalization concerns should not carry the day, given how centrally important credit ratings are to the integrity of the financial markets.

The persuasive force of overcriminalization arguments is much weaker in the context of white-collar crime.[168] Concerns about prison overcrowding and racially distorted criminal conviction data are not present in the white-collar arena.[169] Although some might consider violent crimes

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[165] *See* Cantor, *supra* note 21, at 4 (highlighting the importance of integrity in the credit ratings market because of investor reliance on the high quality of the CRAs' ratings).

[166] Ceresney, *supra* note 15, at 265 ("Investors complained bitterly that delinquencies in residential mortgages had been rising for months prior to the ratings downgrades, and that S&P and Moody's were too slow in correcting the excessively high ratings that had been placed on many classes of bonds backed by subprime mortgages during the housing boom.").

[167] *See, e.g.*, Donald A. Dripps, *Overcriminalization, Discretion, Waiver: A Survey of Possible Exit Strategies*, 109 PENN ST. L. REV. 1155 (2005).

[168] *See* Sara Sun Beale, *The Many Faces of Overcriminalization: From Morals and Mattress Tags to Overfederalization*, 54 AM. U. L. REV. 747, 780 (2005) (stating that overcriminalization is much less likely to occur in the white-collar context because there is much less white-collar enforcement).

[169] In an article analyzing the anti-criminalization movement, Darryl Brown notes the following:

> There is a wide scholarly consensus that American incarceration rates are excessive and racially skewed and that sentencing policies are overly rigid. Expansion of substantive criminal law deserves little blame for this. The dramatic growth in incarceration rates is mostly of a function of new *sentencing* laws rather than new crimes, coupled with greater enforcement of mostly long-standing, familiar crimes, not outdated ones with little popular support.

Darryl K. Brown, *Rethinking Overcriminalization* 51 (Bepress Legal Series, Working Paper No. 995, 2006), *available at* http://law.bepress.com/expresso/eps/995.

categorically more troublesome, white-collar crime can wreak widespread economic havoc on the American public in a way that an individual street crime cannot.[170] White-collar criminal provisions provide a check on the powerful monetary incentives that can motivate white-collar crime. The existence of powerful criminal disincentives in the financial sector shields the American public from the corruptive forces of greed and the catastrophic losses that can result from wrongdoing. The ratings agencies provide a prime example of how misconduct in a white-collar setting can lead to cascading and devastating harms. The traditional overcriminalization arguments do not substantially caution against increasing criminal liability in this arena.

IV. CONCLUSION

Congress should seriously consider restructuring the criminal law controlling the CRAs. In the past decade, the ratings agencies have played a major part in two waves of massive investor losses: the accounting frauds of the early 2000s, and the subprime and credit crises. The stakes have been exceptionally high, and yet the CRAs and all of their underlying actors have escaped without defending a single criminal prosecution. The ratings agencies continue to enjoy immunities and privileges despite their complicity in the worst financial meltdown since the Great Depression. Congress needs to address this lack of accountability and safeguard investors from further abuse.

In the scholarly discourse surrounding mass incarceration, many liberal academics are demanding that policymakers and politicians rethink the penal system. At the same time as this movement for more humanitarian social justice on the streets, there has been a push for more stringent and unforgiving punishment of high-stakes white-collar crime. Despite the concerted advocacy for more corporate and white-collar accountability, the criminal law has not succeeded in disincentivizing egregious corporate misconduct. A clear example of the criminal law's failure is the absence of criminal prosecutions for misconduct by the CRAs. From the standpoints of both retributive justice and deterrence, the state

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[170] *See* Wilson Meeks, *Corporate and White-Collar Crime Enforcement: Should Regulation and Rehabilitation Spell an End to Corporate Criminal Liability?*, 40 COLUM. J.L. & SOC. PROBS. 77, 78 (2010). Meeks makes the case that:

> Corporate and white-collar crimes generate significant costs to the American public. These crimes not only result in direct monetary losses for innocents—such as employees of corporations who lose significant value from their pension and retirement plans or even their jobs—but they also discourage further investment in financial markets. Such a reduction of capital can stifle an economy and result in job loss.

Id. (footnotes and citations omitted).

would be justified in criminally punishing this kind of misconduct. However, the existing law fails to provide sufficiently strict criminal laws.

There are substantive hurdles in the criminal law that obstruct the just, criminal punishment of misconduct at the CRAs. Under the existing law, the ability to impose criminal sanctions on CRA actors who engage in high-risk misconduct is frustrated by a *mens rea* requirement of knowledge or intent. CRA actors can hide behind a shield of complexity. The CRAs should be held to a different standard that acknowledges the importance of an honest, unconflicted market for ratings. A *mens rea* of recklessness will put the CRAs on notice that rubber-stamp ratings will no longer fly under the prosecutorial radar. Moreover, a statute criminalizing misconduct underlying the credit crisis will restore investor trust by promising more stringent punishment of wrongdoing.

The future of the credit ratings industry hangs in the balance. Congress must decide how to address the inadequacies of the existing regulatory framework. An expanded civil liability system that opens the door to investor suits against the CRAs will only further clog the federal courts. Civil regulations and the associated compliance and enforcement would be unduly expensive and burdensome. On the other hand, a narrowly tailored set of criminal provisions could provide a powerful disincentive against misconduct at the CRAs without the expense of regulatory compliance. The absence of a targeted federal criminal law governing the ratings agencies was a get-out-of-jail-free card for the CRAs in the credit crisis. But this is no game of Monopoly—Congress should take those cards out of the deck.