YALE LAW & POLICY REVIEW

Credit Ratings, Congress, and Mandatory Self Reliance

*Zachary Mollengarden**

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires federal agencies to identify, remove, and replace all references to credit ratings in their regulations. It responds to longstanding concerns—heightened by the recent financial crisis—that investors place undue reliance on the opinions of a small number of eminently fallible (and perhaps fundamentally conflicted) credit rating agencies. At first blush, the approach adopted in § 939A appears commonsense: if one wishes to reduce reliance on credit ratings, amending regulations that compel investors to consult credit ratings seems like a straightforward place to start. This Note reconsiders: what appears straightforward in principle has proved to be anything but in practice.

As a targeted critique of § 939A of Dodd-Frank, the Note contend that there is a fundamental mismatch between Congress's diagnosis and prescription. The diagnosis was, inter alia, investor overreliance on credit ratings. Section 939A's prescription, however, was the removal of "any" reference to credit ratings. Separating the two is Congress's failure to recognize that overreliance necessarily implies that some level of dependence on credit ratings remains appropriate. The upshot of Congress's blunt mandate has been a haphazard (and ongoing) process of regulatory reform that, where not facially non-compliant with § 939A, rarely upholds anything more than its letter. As a broader criticism of federal securities regulation, the Note argues that this outcome should not be surprising. Section 939A is afflicted not just by its mismatch between diagnosis and prescription, but also by a flawed motivating ideal best understood as "mandatory self-reliance," or the belief that independence can be compelled.

* Yale Law School, J.D. 2018. I am grateful to Gabriel D. Rosenberg, Max Harris Siegel, and all of the editors at the *Yale Law & Policy Review* for thorough and thoughtful feedback on this piece.

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is primarily concerned with "addition" and "increasing."[1] If Dodd-Frank's 848-page count does not prove the point, a cursory glance through its table of contents should suffice: "increasing investor protection";[2] "increasing regulatory enforcement and remedies";[3] "increased disclosure to investors";[4]

1. Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
2. *Id.* at Title IX, § A.
3. *Id.* at Title IX, § B.
4. *Id.* § 976.

"additional oversight of financial regulatory system";[5] "additional requirements for certain mortgages";[6] and not least, an additional regulatory agency.[7]

Yet Dodd-Frank is not strictly supplemental. Title IX, Subtitle C, § 939A calls for the *removal* of certain text from the Code of Federal Regulations. Section 939A instructs federal agencies to review regulations for "references to or requirements in such regulations regarding credit ratings."[8] After completing this review, the agencies "shall . . . modify any such regulations . . . to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations."[9] In brief, § 939A requires all federal agencies to undertake a three-part exercise of identifying, removing, and replacing references to credit ratings in their regulations.

The immediate impetus for § 939A, like much of Dodd-Frank, was the 2007 financial crisis. Credit rating agencies (CRAs) are institutions, typically privately held,[10] that perform exactly the function their name suggests: evaluating ("rating") the creditworthiness of debt securities and their issuers. In doing so, CRAs mitigate information asymmetries between issuers and investors, thereby facilitating the exchange or purchase of securities between counterparties.

Until they do not. CRAs' overoptimistic assessment of the expected performance of mortgage- and other asset-backed securities has frequently been identified as contributing to (and in one Senate report's view, causing) the recent financial crisis.[11] Scholars and policy-makers have consolidated their criticisms of CRAs under two broad headings. First, they contend that conflicts of

5. *Id.* § 989E.

6. *Id.* § 1433.

7. *See id.* at Title X, "Bureau of Consumer Financial Protection."

8. *Id.* § 939A(a)(2).

9. *Id.* § 939A(b).

10. The imprecision of "typically" is necessary due to recent proposals by the so-called BRICS states (Brazil, Russia, India, China, and South Africa) to establish a public CRA that would adopt a more "appropriate" perspective toward the sovereign debt issued by developing states, thereby further "bridg[ing] the gap in the global financial architecture." *See* Press Trust of India, *BRICS Countries Agree to Set Up Credit Rating Agency*, TIMES OF INDIA (Oct. 17, 2016), http://timesofindia.indiatimes.com/business/india-business/BRICS-countries-agree-to-set-up-credit-rating-agency/articleshow/54881697.cms [http://perma.cc/S5YT-GYT7].

11. *See* STAFF OF UNITED STATES SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS: COMM. ON HOMELAND SECURITY & GOVERNMENTAL AFFAIRS, 112TH CONG., WALL STREET & THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 259 (Comm. Print Apr. 13, 2011) ("Perhaps more than any other single event, the sudden mass downgrades of RMBS and CDO ratings were the immediate trigger for the financial crisis.").

interest are endemic to CRAs' "issuer-pays" business model.[12] The majority of CRAs' revenues stem from fees paid by the issuers of the securities that CRAs evaluate.[13] Those issuers benefit from higher ratings; so—per their critics—CRAs inflate credit ratings to secure repeat business. Second, analysts contend that regulators and investors have outsourced their responsibilities to CRAs.[14] Regulators have done so by mandating reference to specific rating levels in their rules; investors by doing the same in their investment mandates. The upshot is what international and domestic financial regulatory authorities alike have diagnosed as a "mechanistic overreliance" on the opinions of a small number of eminently fallible (and if the first critique is accepted, fundamentally conflicted) firms.[15]

Dodd-Frank § 939A targets the latter critique, overreliance, and at first blush its method appears commonsensical: if one wishes to reduce reliance on credit ratings, amending regulations that compel investors to consult credit ratings appears a straightforward place to start. This Note reconsiders: what appears straightforward in principle has proved to be anything but in practice.

As a targeted critique of § 939A of Dodd-Frank, I contend that there is a fundamental mismatch between Congress's diagnosis and its prescription. The diagnosis was, inter alia, investor *over*reliance on credit ratings. Section 939A's prescription, however, was the removal of "*any*" reference to credit ratings. Separating the two is Congress's failure to recognize that *over*reliance necessarily implies that *some* level of dependence on credit ratings remains appropriate.[16]

12. *See, e.g.*, Lawrence J. White, *The Credit-Rating Agencies and the Subprime Debacle*, 21 CRITICAL REV. 389, 392-93 (2009).

13. *See, e.g.*, Moody's Corporation, Form 10-Q, Nov. 9, 2017 at 43 (indicating that Moody's credit rating arm contributes approximately seventy percent of company revenue); Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, *in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 62 (Yasuyuki Fuchita & Robert E. Litan eds. 2006) (noting that "today roughly 90 percent of credit rating agencies' revenues are from issuer fees"); Bo Becker & Todd Milbourn, *How Did Increased Competition Affect Credit Ratings?* 1, 11 (Harv. Bus. Sch. Working Paper No. 09-051, 2008), http://ssrn.com/abstract=1685691 [http://perma.cc/3825-YXR5].

14. Precisely what those respective responsibilities are varies by commentator. As a general matter, however, analysts call for regulators and investors to perform their various functions with greater independence from CRAs.

15. *See, e.g.*, *Revisions to the Standardised Approach for Credit Risk*, BASEL COMM. ON BANKING SUPERVISION (Dec. 2015); *Joint Consultation Paper on Mechanistic References to Credit Ratings in the ESA's Guidelines and Recommendations*, EUROPEAN BANKING AUTHORITY JOINT COMM. OF THE EUROPEAN SUPERVISORY AUTHORITIES (Nov. 7, 2013); FIN. STABILITY BD., PRINCIPLES FOR REDUCING RELIANCE ON CRA RATINGS (Oct. 27, 2010); FIN. STABILITY BD., REDUCING MECHANISTIC RELIANCE ON CREDIT RATING AGENCY RATINGS: AUSTRALIA'S ACTION PLAN (Mar. 2014).

16. To make the point more concrete: if Congress applied the same logic to combatting obesity, it would require everyone to stop eating.

The upshot of Congress's blunt mandate has been a haphazard (and ongoing) process of regulatory reform that, where not facially non-compliant with § 939A, rarely upholds anything more than its letter.

As a broader criticism of federal securities regulation, I contend that this outcome should not be surprising. Section 939A is afflicted not just by its mismatch between diagnosis and prescription, but also by a flawed motivating ideal best understood as "mandatory self-reliance," or the belief that independence can be compelled. Mandatory self-reliance is not necessarily an oxymoron. We can readily imagine circumstances in which self-sufficiency in fact *requires* motivation.[17] On efficiency and related grounds, this Note argues that sophisticated financial transactions are not one of them.

The remainder of the Note proceeds in four Parts. Part I introduces CRAs, describing their origins and functions before discussing their failures during the 2007 financial crisis. It then reviews the most prominent international regulatory responses in order to indicate the context and impetus for Congressional action in § 939A of Dodd-Frank. Part II begins by discussing the implementation of § 939A throughout the executive branch before focusing on the Securities and Exchange Commission's (SEC's) extended attempt to remove CRA references from Rule 2a-7 of the Investment Company Act, the SEC's central provision regulating money market fund (MMF) investments.

Part III turns from exposition to analysis, arguing that the SEC's revisions to Rule 2a-7 are representative of § 939A's failings as a whole. Congress's categorical approach—mandating the removal of "*any*" references to credit ratings despite seeking to remedy *over*reliance—is likely to have increased ambiguity and cost without a corresponding reduction in regulators or investors' dependence on credit ratings. Moreover, § 939A may undermine related provisions in Dodd-Frank that seek to reduce the conflicts of interest associated with CRAs' "issuer pays" business model. Part IV considers counterarguments and potential paths forward. One path follows the more pragmatic and experimental approach taken by authorities in the European Union (EU). An alternative path, entailing a more fundamental reassessment of the project of moderating investor reliance on CRAs, concludes.

I. The functions, Origins, and failures of CRAs

This Part begins by describing functional explanations for the existence of CRAs. The second Section then briefly reviews the introduction of references to credit ratings and CRAs in U.S. regulations. The final Section discusses CRAs' role in the 2007 financial crisis and the beginnings of the international regulatory response.

17. For example, much like the baby bird, the college graduate may only learn to fly after being tossed from the "nest."

A. Functions

Credit ratings mitigate a problem endemic to all market exchanges: trust.[18] Once markets encompass strangers, members of different linguistic or religious communities, or parties that do not have recourse to a shared means of dispute resolution, trust becomes a central precondition for non-instantaneous exchanges such as lending.[19] Various communities and industries have devised responses—from merchant guilds, to religiously observant middlemen, to the formation of a *lex mercatoria*.[20]

The trust deficit that inspired the creation of CRAs is often more specifically described as an information asymmetry.[21] Applied to the relationship between the issuers of debt securities and potential investors, the asymmetry is a version of the familiar "lemon" problem.[22] Institutional lenders such as banks typically address such asymmetries through initial credit screening and ongoing monitoring of borrowers' finances. Smaller lenders and individual investors often lack the resources to perform such assessments for even the most "vanilla" debt. More complex debt products such as asset-backed securities, which often package together thousands of individual loans, may be beyond the credit screening capacities of even the largest institutions. CRAs serve small and large lenders/investors alike by assessing the creditworthiness of issuers and/or individual securities and assigning a score indicating their relative risk of default. Credit rating agencies thereby promote the efficient distribution of capital, enabling investors to allocate capital with greater precision pursuant to their risk preferences.

So much for the standard account. Among the leading alternative theories, some analysts have suggested that the principal function of CRAs is instead to provide investors with a third-party (and if the fund manager references a credit score pursuant to a regulatory requirement, also a governmental) stamp of ap-

18. Trust is implicit—and for the etymologically minded, explicit—in the term "credit" itself. "Credit" derives from the Latin *credere*, meaning to believe or entrust. *Credit: Origin and Etymology of Credit*, MERRIAM-WEBSTER, http://www.merriam-webster.com/dictionary/credit [http://perma.cc/4MGR-VGKA].

19. A "non-instantaneous exchange" simply refers to a transaction in which one party pays today and the other (re)pays sometime later. The important feature of this exchange, for present purposes, is that the former party must trust that the latter will perform.

20. Known in English as the "Law Merchant." *See generally* J. H. Baker, *The Law Merchant and the Common Law before 1700*, 38 CAMBRIDGE L.J. 295 (1979).

21. *See, e.g.*, Arnoud Boot et al., *Credit Ratings as Coordinated Mechanisms*, 19 REV. FIN. STUD. 81 (2006); Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Agency Accuracy Through Incentive Compensation*, 27 YALE J. REG. 91 (2010).

22. George A. Akerloff, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

proval for their decisions.[23] According to this account, the financial information that CRAs provide is of secondary importance to the reputational signal their ratings send. Alternative theories focus on the role of CRAs in systematizing and organizing extensive and often disparate financial information.[24] Analysts subscribing to this view maintain that in financial markets awash with data, the primary value of CRAs is in consolidating this information into a single, comprehensible, and communicable credit score.[25] Still other analysts argue that modern CRAs serve no function at all,[26] and are merely a relic of misguided regulatory decisions at a time when investors lacked access to reams of financial information and analysis with the stroke of a few keys. Well into the 21st century, these alternative (non)functional accounts attracted relatively few adherents. After the 2007 financial crisis, however, the critics appeared Cassandras.[27] The next Section sets the stage for the 2007 crisis by reviewing the origins and expansion of the rating industry as well as the introduction of references to credit ratings and CRAs by U.S. regulators.

23. *See, e.g.*, Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH U. L. Q 619 (1999); *see also* Thomas McGuire, Executive Vice President, Moody's, "Ratings in Regulation: A Petition to the Gorillas," Address at the SEC Fifth Annual International Institute for Securities Market Development (Apr. 28, 1995) ("By using securities ratings as a tool of regulation, governments fundamentally change the nature of the product agencies sell. Issuers then pay rating fees to purchase, not credibility with the investor community, but a license from a government."), *quoted in* Viktoria Baklanova, *Regulatory Use of Credit Ratings: How It Impacts the Behavior of Market Constituents*, *in* CREDIT, CURRENCY, OR DERIVATIVES: INSTRUMENTS OF GLOBAL FINANCIAL STABILITY 92 (J. Jay Choi & Michael G. Papaioannou eds., 2009).

24. *See, e.g.*, Robert J. Rhee, *Why Credit Rating Agencies Exist*, 44 ECON. NOTES 161, 171–73 (2015) ("Rating agencies are institutions necessary for a more efficient market in which available information is centrally processed at cheaper cost than on a disaggregated basis at higher labour costs" and comparing agencies to libraries that "produce little new information" but "collect and organise information for the benefit of research by others.").

25. For the visual learner, picture reducing a spreadsheet with tens of thousands of entries into the letter "A."

26. Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA. L & BUS. REV. 10, 21 (2006) ("It is generally accepted that the uninformed investors who inhabit financial markets clearly rely on the ratings generated by the major credit rating agencies. Why this is the case is something of a mystery.").

27. *See* Cassandra, ENCYCLOPEDIA BRITANNICA, http://www.britannica.com/topic/Cassandra-Greek-mythology [http://perma.cc/ZQ69-M56R].

B. Origins

Lewis Tappan was already a notoriously strict judge of character when he joined his brother's silk business in New York in the mid-19th century.[28] Along with learning the trade, Tappan spent much of his time maintaining meticulous records of the firm's finances and the debts it was owed by counterparties.[29] These records proved invaluable to Tappan and colleagues throughout the New York silk trade during the panic of 1837. With business still depressed in 1841, Tappan sought to develop an alternative revenue stream.[30]

Drawing upon a network of contacts in the abolitionist movement, Tappan established The Mercantile Agency.[31] By 1844 the Agency had branches in Boston, Philadelphia, and Baltimore; by 1851, two thousand full-time correspondents were investigating the creditworthiness of firms in various industries across the country.[32] Competition from established commercial reporting firms such as Standard and Poor's Publishing soon followed.[33]

The first reference to a credit rating in U.S. regulatory text followed the stock market collapse that began the Great Depression. Federal securities regulators' responses were driven by two main ambitions. First, they sought a means of encouraging the growing number of retail investors to place their capital with more "stable" banks and other financial firms. Second, they wanted to impose stricter restrictions on the investment practices of institutions whose mass de-

28. Both Lewis and his brother were staunch evangelical Christians, known in the neighborhood for distributing bibles outside their store and entering into brothels to "pluck fallen women from roaring lions who seek to devour them." Lewis Tappan, PBS: WHO MADE AMERICA, http://www.pbs.org/wgbh/theymadeamerica/whomade/tappan_hi.html [http://perma.cc/7GUD-SYB8]; *see also* LEWIS TAPPAN, THE LIFE OF ARTHUR TAPPAN (1870).

29. *See* Lewis Tappan, PBS, *supra* note 28.

30. *Id.*

31. The Mercantile Agency is the corporate predecessor of Dun & Bradstreet, a commercial data firm listed on the New York Stock Exchange boasting data on more than 285 million companies worldwide. *See Our Worldwide Network,* DUN & BRADSTREET (last visited on Apr. 11, 2018), http://www.dnb.com/about-us/our-worldwide-network.html [http://perma.cc/BB5M-CQZL].

32. *See* Lewis Tappan, PBS, *supra* note 28; NICOLA JENTZSCH, FINANCIAL PRIVACY: AN INTERNATIONAL COMPARISON OF CREDIT REPORTING SYSTEMS 63 (2006); BERTRAM WYATT-BROWN, LEWIS TAPPAN AND THE EVANGELICAL WAR AGAINST SLAVERY (1969).

33. *See Our History*, S&P GLOBAL, http://www.spglobal.com/who-we-are/our-company/our-history [http://perma.cc/5SSL-3WMT] (last visited Apr. 11, 2018) (noting that in 1860 Henry Varnum Poor published an investor's guide to the U.S. railroad industry that "provide[d] essential insights into the railroad industry and help[ed] investors leverage that intelligence into smart investment decisions").

faults exacerbated the crisis.[34] Mandating that institutional lenders refer to credit ratings advanced both goals, and in 1936 the Office of the Comptroller of the Currency (OCC) for the first time required banks to apply distinct accounting treatments for "speculative" and "investment grade" bonds. The OCC defined the latter with reference to "recognized rating manuals," such as that issued by Standard and Poor's.[35]

References to credit ratings in federal regulations remained relatively sparse until 1975. That year, the SEC introduced the term "nationally recognized statistical rating organization" (NRSRO) into its rules detailing net capital requirements for broker-dealers.[36] The SEC sought to establish a "reasonably objective" benchmark for assigning capital charges to various debt instruments, and it described the NRSRO designation as a means of ensuring such objectivity by privileging the ratings of the most reliable and accurate CRAs.[37] The ratings provided by CRAs that gained NRSRO status received, in effect, a governmental stamp of approval.

Regulatory references to credit ratings soon proliferated, with "investment grade" and analogous citations serving as convenient shorthand for the financial safety and security that is a central component of various regulators' mandates.[38] By 1997, more than one thousand securities regulations referenced

34. ALINE DARBELLAY, REGULATING CREDIT RATING AGENCIES 17–23 (2013).

35. *See* COMPTROLLER OF THE CURRENCY, PURCHASE OF INVESTMENT SECURITIES AND FURTHER DEFINING THE TERM 'INVESTMENT SECURITIES' AS USED IN SECTION 5136 OF THE REVISED STATUTES AS AMENDED BY THE 'BANKING ACT OF 1935' (Feb. 15, 1936); *see also Standard and Poor's Corporate Ratings Criteria* 9 (2001), *cited in* Steven L. Schwacz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 7–8.

36. *See* SEC, NOTICE OF REVISION PROPOSED AMENDMENTS TO RULE 15C3-1 UNDER THE SECURITIES EXCHANGE ACT OF 1934 (1973), Release No 34-10,525, 1973 SEC LEXIS 2309; *see also* 17 C.F.R. 240.15c3-1 (July 16, 1975).

37. *See* Definition of Nationally Recognized Statistical Rating Organization, 70 Fed. Reg. 21,306, 21,311 (proposed Apr. 25, 2005) (to be codified at 17 C.F.R. pt. 240); SEC, NOTICE OF REVISION PROPOSED AMENDMENTS TO RULE 15C3-1 ("The Commission to a limited extent has also recognized the usefulness of the nationally recognized statistical rating organizations as a basis for establishing a dividing line for securities with a greater or lesser degree of market volatility.").

38. Discussing the history of the concept in a 2005 proposed rule, the SEC noted that it had utilized the term in the following regulations: "17 CFR 228.10(e), 229.10(c), 230.134(a)(14), 230.436(g), 239.13, 239.32, 239.33, 240.3a1- 1(b)(3), 240.10b-10(a)(8), 240.15c3-1(c)(2)(vi)(E), (F), and (H), 240.15c3-1a(b)(1)(i)(C), 240.15c3-1f(d), 240.15c3-3a, Item 14, Note G, 242.101(c)(2), 242.102(d), 242.300(k)(3) and (l)(3), 270.2a-7(a)(10), 270.3a-7(a)(2), 270.5b-3(c), and 270.10f-3(a)(3)." The Commission goes on to note that Congress has also found the concept useful, incorporating the term NRSRO into diverse legislation, including:

NRSROs. Another 1,200 references appeared in regulations addressing banking, real estate, and pensions.[39]

The proliferation of references is partly a function of the expanding size and complexity of credit markets. Yet volume alone tells an incomplete story. Defining vague regulatory ambitions such as "financial safety" and "investment security" with reference to credit ratings assigned by CRAs advanced regulatory and investors' interests alike. Echoing the critics discussed above, however, this may be because it absolved both of responsibility.

C. *Failures*

In 2003, the SEC consulted industry participants concerning its references to credit ratings. Many respondents—including some credit agencies[40]—argued that the SEC should remove the references entirely. The majority argued that before taking such a step the SEC was obliged to identify a viable alternative. Seeing none, the SEC took no action.

The force and urgency of the critiques noted above multiplied after the 2007 financial crisis.[41] Analysts and policy makers identified CRAs' overoptimis-

---

15 U.S.C. 78c(a)(41) (defining the term "mortgage related security"); 15 U.S.C. 78c(a)(53)(A) (defining the term "small business related security"); 15 U.S.C. 80a-6(a)(5)(A)(iv)(I) (exempting certain companies from the provisions of the Investment Company Act of 1940); Gramm-Leach-Bliley Act, Pub. L. No. 106–102 (1999); Transportation Equity Act for the 21st Century, Pub. L. No. 105–178 (1998); Reigle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103–325 (1994); Department of Commerce, Justice, and State, The Judiciary, and Related Agencies Appropriations Act, FY2001, Pub. L. No. 106–553 (2000); Higher Education Amendments of 1992, Pub. L. No. 102–325 (1992); Housing and Community Development Act of 1992, Pub. L. No. 102–550 (1992); Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102–242 (1991); and Financial Institutions Reform, Recovery, and Enforce-ment Act of 1989, Pub. L. No. 101–72 (1989).

See Definition of Nationally Recognized Statistical Rating Organization, 70 Fed. Reg. 21,306 (proposed Apr. 25, 2005) (to be codified at 17 C.F.R. pt. 240) at nn.5, 11.

39. *Global Financial Stability Report: Sovereigns, Funding, and Systemic Liquidity*, INT'L MONETARY FUND 92 (Oct. 2010), http://www.imf.org/en/Publications/GFSR Issues/2016/12/31/Sovereigns-Funding-and-Systemic-Liquidity [http://perma.cc/E93Q-XEX9].

40. *See, e.g.*, Moody's Investment Service, *Comment Letter on File No. S7-12-03 Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws* (July 28, 2003), http://www.sec.gov/rules/concept/s71203/moodys072803.htm [http://perma.cc/5XZF-XPWR] ("If ratings cease to be used for regulatory purposes, we believe that credit rating agencies can continue to serve their primary objectives in support of market efficiency and investor protection.").

41. *See supra* notes 21-27 and accompanying text.

tic assessments of mortgage-backed securities as a principal cause of the inflation and collapse of the U.S. housing bubble.[42] The causal account is damning[43]: inaccurate credit ratings supported the sale of "toxic" securitized mortgage products to investment funds. Because the funds and the issuers of the products benefited from these transactions, demand for the underlying loans increased, encouraging lenders to lower their credit standards in order to ensure adequate supply. The upshot, "when the music stop[ped],"[44] was an economy-wide crisis comparable to the Great Depression.

Just as the stock market crash of 1929 brought about the first regulatory reference to credit ratings, so the 2007 crisis appeared to herald the demise of the practice. In April 2008, the Financial Stability Forum—an institution comprising national authorities responsible for financial stability in the G7 countries, succeeded in 2009 by the Financial Stability Board (FSB)—issued a report calling for national regulators to curtail investors and regulators' reliance on credit ratings.[45] Principle IV.8 of the FSB's "Report on Enhancing Market and Institutional Resilience" called for national regulators to "check that the roles that they have assigned to ratings in regulations and supervisory rules are consistent with the objectives of having investors make independent judgment of risks and perform their own due diligence, and that they do not induce uncritical reliance on credit ratings."[46]

---

42. *See, e.g.*, WALL STREET AND THE FINANCIAL CRISIS, *supra* note 11, at 289–94.

43. It is also popular. *See*, *e.g.*, John C. Coffee, Jr., *Ratings Reforms: The Good, The Bad and The Ugly*, 1 HARV. BUS. L. REV. 231, 236–46 (2011); Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures In The Build Up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111, 1122–23 (2009); Elizabeth Devine, *The Collapse Of An Empire? Rating Agency Reform in the Wake of the 2007 Financial Crisis*, 16 FORDHAM J. CORP. & FIN. L. 177, 178 (2011) ("As analysts begin to investigate who is to blame for the current financial situation, some argue it was the fault of over-zealous lenders, others say that homeowners were simply borrowing well beyond their means, but many analysts now point fingers at the rating agencies themselves.").

44. The now-infamous quote comes from then-chief executive of Citigroup, Chuck Prince, who in a July 2007 interview told the *Financial Times* that "when the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Michiyo Nakamoto & David Wighton, *Citigroup Chief Stays Bullish on Buy-outs*, FIN. TIMES (July 9, 2007), http://www.ft.com/content/80e2987a-2e50-11dc-821c-0000779fd2ac [http://perma.cc/PBB2-E5MK].

45. *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, FIN. STABILITY FORUM 32–40 (Apr. 7, 2008), http://www.fsb.org/wp-content/uploads/r_0804.pdf [http://perma.cc/6THV- PKUD].

46. *Id.* at 38.

Two years later, the FSB published its "Principles for Reducing Reliance on CRA Ratings."[47] The FSB consolidated its recommendations into two general principles designed to serve as a framework for domestic reforms. Principle I calls for reducing reliance on CRA ratings in standards, laws, and regulations.[48] In particular, it instructs domestic authorities to identify references to CRAs in their regulations and, "wherever possible, remove them or replace them by suitable alternative standards of creditworthiness."[49] Principle II extends to the private sector, calling for "banks, market participants and institutional investors to make their own credit assessments, and not rely solely or mechanistically on CRA ratings."[50] The Bank for International Settlements,[51] the International Organization of Securities Commissions,[52] and other multilateral regulatory institutions (including the International Monetary Fund,[53] United Nations,[54] and World Bank[55]) have expressed support for the FSB's approach.

In between these two FSB initiatives, the United States had its own say on the matter. Title IX, Subtitle C of Dodd-Frank addresses "Improvements to the Regulation of Credit Rating Agencies."[56] Its nine sections target the two principal critiques of CRAs levied after the crisis: regulators' and investors' overreliance on credit ratings, and conflicts of interest associated with CRAs' "issuer pays" business model.[57] Overreliance is the focus of §§ 939 and 939A. Section 939 mandates the removal of specific references to credit ratings in various stat-

47. *Principles for Reducing Reliance on CRA Ratings*, FIN. STABILITY BD. (Oct. 27, 2010), http://www.fsb.org/wp-content/uploads/r_101027.pdf [http://perma.cc/2GCS-LR7Y].

48. *Id.* at 1.

49. *Id.*

50. *Id.* at 2.

51. *See Revisions to the Standardised Approach for Credit Risk*, BANK INT'L SETTLEMENTS 4 (Dec. 2015), http://www.bis.org/bcbs/publ/d347.pdf [http://perma.cc/LA8V-CW9P].

52. *See Sound Practices at Large Intermediaries: Alternatives to the Use of Credit Ratings to Assess Creditworthiness*, INT'L ORG. OF SEC. COMM'NS (Dec. 2015) http://www.iosco.org/library/pubdocs/pdf/IOSCOPD524.pdf [http://perma.cc/P9YU-ZJRG].

53. *See* INT'L MONETARY FUND, *supra* note 39, at 85–122.

54. *See* Press Release, General Assembly, General Assembly Examines Growing Role of Credit Rating Agencies as Arbiters of Risk, While Speakers Call for Common Standards, Objectivity, Reforms, U.N. Press Release GA/11409 (Sept. 10, 2013).

55. Jonathan Katz et al., *Credit Rating Agencies: No Easy Regulatory Solutions*, WORLD BANK GROUP: CRISIS RESPONSE POLICY BRIEF 6 (Oct. 2009).

56. Pub. L. No. 111–203 at Title IX, § C.

57. *Id.* §§ 931–939(A)-(H).

utes;[58] Section 939A orders that federal agencies complete the same exercise for all of their regulations.[59]

The following Part first analyzes § 939A's mandate and its implementation across the executive branch before turning to the SEC's five-year attempt to remove references to credit ratings from Rule 2a-7, the Commission's primary rule governing MMFs. I thereby set out the empirical foundations for the analysis that follows in Part III.

II. Dodd-Frank § 939A

A. *Text and Implementation*

Section 939A mandates that federal agencies identify, remove, and replace regulatory references to credit ratings. First, it instructs that each federal agency "shall," within one year of the date of enactment, review "(1) any regulation issued by such an agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and (2) any references to or requirements in such regulations regarding credit ratings."[60] Second, each agency "shall modify any such regulations . . . to remove any reference to or requirement of reliance on credit ratings"—a notable departure from the FSB's call to remove such references "wherever possible."[61] Third, each agency "shall . . . substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations."[62]

The dictate to remove statutory references to credit ratings was first contemplated by the House Financial Services Committee pursuant to an amendment introduced by Representatives Scott Garrett and Spencer Bachus to the Accountability and Transparency in Rating Agencies Act, a bill that never received a vote in the House.[63] Some components of the Accountability Act, including its tenth section, "Review of Reliance on Ratings," nonetheless later

58. *E.g.* Federal Deposit Insurance Act, Pub. L. 114-113, § 28(d), 64 Stat. 873 (codified as amended in 12 U.S.C. § 1811 *et seq.* (2015)) (removing "not of investment grade" and inserting "that does not meet standards of credit-worthiness as established by the Corporation").

59. Dodd-Frank, Pub. L. No. 111-203, § 939A(a)-(b), 124 Stat. 1376, 1887 (2010) ("Not later than 1 year after the date of the enactment of this subtitle, each Federal agency shall . . .modify any such regulations . . . to remove any reference to or requirement of reliance on credit ratings.").

60. *Id.* § 939A(a)(1)-(2).

61. *Id.* § 939A(b).

62. *Id.*

63. *See* Press Release, House Comm. on Fin. Servs., Bachus, Garrett Amendment to Reduce Reliance on Credit Ratings Approved by Committee (Oct. 27, 2009), http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=227824 [http://perma.cc/PR58-3NHY]; H. Rep. No. 111-685 (2010).

made their way into the text of Dodd-Frank following further drafting by Garrett, Bachus, and Dodd-Frank's co-sponsor, Representative Barney Frank.[64] During a 2012 Committee on Financial Services hearing, Garrett described the impetus for the provision as "broad agreement that investors, because of the government's explicit requirement of ratings, had become basically over-reliant on the rating agencies and failed to do their due diligence."[65]

The Congressional response to investors' overreliance on credit ratings was logical, if blunt: in lieu of the FSB's discretionary "wherever possible," § 939A instructs the agencies to "remove any reference." A full review of its implementation is beyond the scope of this Note.[66] For present purposes, it is adequate to develop a general sense of the diversity of approaches. The ensuing discussion of the SEC's efforts to reform rule 2a-7 will then provide the empirical depth needed to support Part III's normative analysis.[67]

The following tables review a sample of the implementation strategies pursued by five federal agencies. Each table's second and third columns compare the language of targeted regulations before and after the agency deemed itself compliant with § 939A. Italicized text indicates the relevant amendment, or lack thereof. Following each table, I briefly highlight salient aspects of the process or result.

64. *See Oversight of the Credit Rating Agencies Post-Dodd-Frank*: *Hearing Before the Subcomm. on Oversight & Investigations of the H. Comm. on Fin. Servs.*, 112th Cong. 5 (July 27, 2011) (statement of Rep. Garrett, Member, H. Subcomm. on Oversight & Investigations of the Comm. on Fin. Servs.) ("Ranking Member Frank, Chairman Bachus and I crafted language to remove all rating requirements from the statutes and the regulations. So, I am pleased to see that in some regards, the regulatory community has been moving forward on implementing that.").

65. *Id.*; *see also Oversight of the Credit Rating Agencies Post-Dodd-Frank*: *Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Servs.*, *supra* note 64 (statement of Rep. Fitzpatrick, Vice Chairman, H. Subcomm. on Oversight & Investigations of the Comm. on Fin. Servs.) ("I think it is striking that one of the few bipartisan understandings to come out of Dodd-Frank was that reliance on credit ratings have become too ingrained and too pervasive in our statutes.").

66. Those seeking a review focusing on how federal agencies may or may not have learned from each other's efforts in implementing § 939A should consult Francesco De Pascalis's thorough study. Francesco De Pascalis, *Reducing Regulatory Reliance on Credit Ratings to Address Investors' Over-reliance: Some Thoughts in Light of the US Experience*, 11 CAPITAL MARKETS L.J. 510 (2016).

67. *See infra* Part II.B.1–3.

Regulator	Pre § 939A	Post § 939A
Commodities Futures Trading Commission (CFTC)	17 C.F.R. § 1.49: Denomination of customer funds and location of depositories. (d) Qualifications for depositories (3) A depository, if located outside the United States, must be: (i) A bank or trust company: (A) That has in excess of $1 billion of regulatory capital; or (B) Whose commercial paper or long-term debt instrument or, if a part of a holding company system, *its holding company's commercial paper or long-term debt instrument, is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization*; (ii) A futures commission merchant that is registered as such with the Commission; or . . . .[68]	17 C.F.R. § 1.49: Denomination of customer funds and location of depositories (d) Qualifications for depositories (3) A depository, if located outside the United States, must be: (i) A bank or trust company that has in excess of $1 billion of regulatory capital; (ii) A futures commission merchant that is registered as such with the Commission; or . . . . [69]

The CFTC completed the first (investigation) and second (removal) steps mandated by § 939A. Note, however, that Rule 1.49 does not provide an alternative measure of creditworthiness to replace the previous reference to NRSROs. It thus does not, as required, "substitute in such regulations such standard

68. 17 C.F.R. § 1.49(d)(3)(i)(B) (2009) (emphasis added).

69. *Id.* at § 1.49(d)(2).

of credit-worthiness as [it] determine[s] . . . appropriate for such regulations."[70] That said, the CFTC could argue that the "substitute" it has determined is most appropriate is no standard at all.

Regulator	Pre § 939A	Post § 939A
Office of the Comptroller of the Currency (OCC)	12 C.F.R. § 28.15: Capital equivalency deposits For purposes of section 4(g) of the IBA, 12 U.S.C. 3102(g), unless otherwise provided by the OCC, a foreign bank's capital equivalency deposits (CED) must consist of: (iii) Certificates of deposit, payable in the United States, and banker's acceptances, *provided that, in either case, the issuer or the instrument is rated investment grade by an internationally recognized rating organization, and neither the issuer nor the instrument is rated lower than investment grade by any such rating organization that has rated the issuer or the instrument.* [71]	12 C.F.R. § 28.15: Capital equivalency deposits For purposes of section 4(g) of the IBA, 12 U.S.C. 3102(g), unless otherwise provided by the OCC, a foreign bank's capital equivalency deposits (CED) must consist of: (iii) Certificates of deposit, payable in the United States, and banker's acceptances, *provided that, in either case, the issuer has an adequate capacity to meet financial commitments for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.* [72]

The OCC's revision provides an alternative metric for creditworthiness—"adequate capacity to meet financial commitments"—to replace previous references to "internationally recognized rating organization[s]" and whether or not the instrument was rated investment grade "by such rating organization."

Note that the OCC's revised regulation also defines "adequate capacity," although without adding a great deal of precision. The indicators for "adequate capacity" include a low risk of default and the expectation of full and timely repayment—factors that could be considered more tautological than descriptive.

70. Dodd-Frank, Pub. L. No. 111-203, § 939A(b), 124 Stat. 1376, 1887 (2010).

71. 12 C.F.R. § 28.15(a) (2010) (emphasis added).

72. 12 C.F.R. § 28.15(a) (2014) (emphasis added).

Regulator	Pre § 939A	Post § 939A
National Credit Union Administration (NCUA)	12 C.F.R. § 703.8: Broker-dealers (b) Before purchasing an investment through a broker-dealer, a Federal credit union must analyze and annually update the following: (3) If the broker-dealer is acting as the Federal credit union's counterparty, the ability of the broker-dealer and its subsidiaries or affiliates to fulfill commitments, as evidenced by capital strength, liquidity, and operating results. *The Federal credit union should consider current financial data, annual reports, reports of nationally-recognized statistical rating organizations, relevant disclosure documents, and other sources of financial information.*[73]	12 C.F.R. § 703.8: Broker-dealers (b) Before purchasing an investment through a broker-dealer, a Federal credit union must analyze and annually update the following: (3) If the broker-dealer is acting as the Federal credit union's counterparty, the ability of the broker-dealer and its subsidiaries or affiliates to fulfill commitments, as evidenced by capital strength, liquidity, and operating results. *The Federal credit union should consider current financial data, annual reports, external assessments of creditworthiness, relevant disclosure documents, and other sources of financial information.*[74]

Rather than deleting (like the CFTC) or replacing (like the OCC), the NCUA chose to rephrase its reference to credit ratings. In lieu of the "reports of nationally-recognized statistical rating organizations," the NCUA now refers to "external assessments of creditworthiness." Both NRSROs and "external assessments" are arguably captured under the rule's concluding reference to "other sources of financial information," suggesting that the NCUA wished to retain a reference to CRAs and their work product but was obliged to do so without using the (now verboten) magic words.[75]

73. 12 C.F.R. § 703.8(b) (2010) (emphasis added).

74. 12 C.F.R. § 703.8(b) (2014) (emphasis added).

75. For further detail on the NCUA's actions to comply with § 939A, see Nat'l Credit Union Admin., CORPORATE CREDIT UNION GUIDANCE LETTER NO. 2013-01, FINAL RULE–ALTERNATIVES TO THE USE OF CREDIT RATINGS (2013), http://www.ncua

Regulator	Pre § 939A	Post § 939A
Federal Housing Finance Agency (FHFA)	12 C.F.R. §1267.3: Prohibited investments and prudential rules. (a) Prohibited investments. A Bank may not invest in: . . . (3) Debt instruments that are *not rated as investment grade*, except: … (ii) Debt instruments that were *downgraded to a below investment grade* rating after acquisition by the Bank; (4) Whole mortgages or other whole loans, or interests in mortgages or loans, except: … (iii) *Marketable direct obligations of state, local, or Tribal government units or agencies, having at least the second highest credit rating from an NRSRO*, where the purchase of such obligations by the Bank provides to the issuer the customized terms, necessary liquidity, or favorable pricing required to generate needed funding for housing or community lending . . . .[76]	12 C.F.R. § 1267.3: Prohibited investments and prudential rules. (a) Prohibited investments. A Bank may not invest in: . . . (3) Debt instruments that are *not investment quality*, except: … (ii) Debt instruments *that a Bank determined became less than investment quality* because of developments or events that occurred after acquisition of the instrument by the Bank; (4) Whole mortgages or other whole loans, or interests in mortgages or loans except: … (iii) *Marketable direct obligations of state, local, or Tribal government units or agencies, that are investment quality*, where the purchase of such obligations by the Bank provides to the issuer the customized terms, necessary liquidity, or favorable pricing required to generate needed funding for housing or community lending . . . .[77]

.gov/regulation-supervision/Pages/policy-compliance/communications/corporate-guidance-letters/lccu2013-01.aspx [http://perma.cc/X6L5-5FZF].

76. 12 C.F.R. §1267.3(a) (2012) (emphasis added).

77. 12 C.F.R. §1267.3(a) (2017) (emphasis added).

In 2013, the OCC, Federal Reserve, and FDIC completed a "Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions."[78] A December 2016 advisory bulletin[79] from the FHFA directs parties interested in its definition of "investment grade" to this agreement.

The Uniform Agreement defines "investment grade" as follows: "A security is investment grade if the issuer of the security has an adequate capacity to meet financial commitments for the life of the asset." The Agreement then refers banks and saving associations to "the regulations of [their] appropriate federal banking agency" for further guidance. Note, however, that the Uniform Agreement does not define "investment quality," (as appears in § 1267.3(a)(3)(4)(iii)), nor identify whether there is a substantive distinction between "investment grade" and "investment quality."

Regulator	Pre § 939A	Post § 939A
Federal Deposit Insurance Corporation (FDIC)	12 C.F.R. § 347.209: Pledge of assets (d) Assets that may be pledged. Subject to the right of the FDIC to require substitution, a foreign bank may pledge any of the kinds of assets listed in this paragraph (d); such assets must be denominated in United States dollars. A foreign bank shall be deemed to have pledged any such assets for the benefit of the FDIC or its designee at such time as any such asset is placed with the depository, as follows: . . . *(3) Commercial paper that is rated P–1 or P–2, or their equivalent by a nationally recognized rating service; provid-*	12 C.F.R. § 347.209: Pledge of assets (d) Assets that may be pledged. Subject to the right of the FDIC to require substitution, a foreign bank may pledge any of the kinds of assets listed in this paragraph (d); such assets must be denominated in United States dollars. A foreign bank shall be deemed to have pledged any such assets for the benefit of the FDIC or its designee at such time as any such asset is placed with the depository, as follows: . . . *(3) Commercial paper that is rated P–1 or P–2, or their equivalent by a nationally recognized rating service; provid-*

78. OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., U.S. DEPT. OF THE TREASURY, OCC BULL. NO. 2013-28, UNIFORM AGREEMENT ON THE CLASSIFICATION AND APPRAISAL OF SECURITIES HELD BY DEPOSITORY INSTITUTIONS (2013).

79. FED. HOUSING FIN. AGENCY, ADVISORY BULLETIN: CLASSIFICATION OF INVESTMENT SECURITIES AT FHLBANKS AB 2016-01 (2016).

	ed, that any conflict in a rating shall be resolved in favor of the lower rating . . . . [80]	*ed, that any conflict in a rating shall be resolved in favor of the lower rating . . . .* [81]

Seven years after Congress passed Dodd-Frank and six years after the FDIC presumptively complied with § 939A's mandate to assess all references to credit ratings, the FDIC has yet to amend this provision addressing permissible asset pledges for insured U.S. branches of foreign banks.

The FDIC issued a notice of proposed rulemaking on June 21, 2016 indicating its intention to replace the current reference to NRSROs with "investment grade."[82] The FDIC proposed to define "investment grade," for the purposes of this regulation, as "a security whose issuer has adequate capacity to meet all financial commitments under the security for the projected life of the exposure. Such an entity has adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected."[83] This definition mimics that used elsewhere by the FDIC and in the 2013 Uniform Agreement.

* * *

It is difficult to identify a common theme in these revisions (or lack thereof) to the regulatory texts. The CFTC appears to have interpreted § 939A as merely requiring deletion; while for the OCC, "rated investment grade by an internationally recognized rating organization" became "has an adequate capacity to meet financial commitments."[84] The OCC's explanation of what constitutes "adequate capacity," however, does little to clarify the new standard. The FDIC has yet to finalize its proposed revisions, and it bears noting that none of the agencies canvassed above has attempted to prevent regulated parties from consulting credit ratings. Indeed, as discussed in greater detail below, agency guidance has repeatedly underscored the expectation that investors will continue to use credit ratings.[85]

80. 12 C.F.R. § 347.209(d) (2010) (emphasis added).

81. 12 C.F.R. § 347.209(d) (2017) (emphasis added).

82. *See* Alternatives to References to Credit Ratings with Respect to Permissible Activities for Foreign Branches of Insured State Nonmember Banks and Pledge of Assets by Insured Domestic Branches of Foreign Banks, 81 Fed. Reg. 41,877, 41,889-91 (June 28, 2016) (to be codified at 12 C.F.R. pt. 347).

83. *Id.* at 41879.

84. *Compare* 12 C.F.R. § 28.15(a) (2010) *with* 12 C.F.R. § 28.15(a) (2014).

85. *See, e.g.*, Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, 80 Fed. Reg. 58,124, 58,133 (Sept. 25, 2015) (to be codified at 17 C.F.R. pts. 270, 274) ("[U]nder the proposed amendments, funds could continue to test their portfolios against a potential downgrade or default in addition to any other indication or

A 2016 report from the Treasury Department's Office of Financial Research[86] sought to impose some order on federal agencies' strategies for complying with § 939A by proposing a three-part typology. According to the report, the agencies' most common strategy has been definitional. Under this approach, regulators replace references to credit ratings with a definition that aims to capture the same substantive features, but without explicitly referring investors to third parties such as CRAs.[87] The OCC's explanation of "adequate capacity to meet financial commitments" detailed in Table 1 is indicative.

A second strategy entails mandating that regulated parties assess creditworthiness using designated financial models.[88] Thus banking regulators (including the Department of the Treasury, OCC, Federal Reserve, and FDIC) have introduced or modified certain models used to calculate banks' capital requirement for securitized products in order to eliminate references to credit ratings on the underlying obligations.[89]

The third strategy entails replacing references to CRAs with references to alternative third party evaluators.[90] For example, some banking regulators have replaced references to CRA ratings of sovereign debt with references to the Organization for Economic Cooperation and Development's Country Risk Classifications, notwithstanding the Organization's caveat that "[t]he country risk classifications are not sovereign risk classifications and should not, therefore, be compared with the sovereign risk classifications of private credit rating agencies (CRAs)."[91]

Part III analyzes the wisdom of these and other approaches to implementing § 939A. Before doing so, the following Section undertakes a more in-depth review of one agency's experience revising a single provision: the SEC and rule

evidence of credit deterioration they determine appropriate."). *See generally* Part III.a.i.

86. JOHN SOROUSHIAN, OFFICE OF FIN. RESEARCH, BRIEF NO. 16-04, CREDIT RATINGS IN FINANCIAL REGULATION: WHAT'S CHANGED SINCE THE DODD-FRANK ACT? (Apr. 21, 2016).

87. *Id.* at 3.

88. *Id.*

89. *See, e.g.*, Regulatory Capital Rules, 79 Fed. Reg. 20,754, 20,760–61 (Apr. 14, 2014) (detailing the "Simplified supervisory formula approach").

90. Soroushian, *supra* note 86, at 3–4.

91. *Country Risk Classification*, OECD (Dec. 21, 2017), http://www.oecd.org/trade/xcred/crc.htm [http://perma.cc/QR6W-PECR] (noting, in bold text, that the country risk classifications are "produced solely for the purpose of setting minimum premium rates for transactions" supported by the OECD's Export Credits Arrangement)*; see also* Risk-Based Capital Guidelines: Market Risk, 77 Fed. Reg. 53,059, 53,075-77 (Aug. 30, 2012) ("While recognizing that CRCs [country risk classifications] have certain limitations, the agencies consider CRCs to be a reasonable alternative to credit ratings . . . .").

2a-7 of the Investment Company Act. This five-year saga highlights several reasons for concern alluded to in the preceding review.

B. *The SEC and Rule 2a-7*

Money market funds are a form of mutual fund developed in the 1970s in order to provide investors with a higher-yielding, but still relatively secure, alternative to interest-bearing bank accounts.[92] Money market funds typically invest in high-quality, short-maturity debt instruments whose dividends approximate inter-bank lending rates of similar tenures. For investors, MMFs are often used to earn a small return while assessing where to deploy capital on a longer-term basis.[93] The SEC's Division of Investment Management reports that MMFs held $2.9 trillion in total assets as of May 31, 2017, $2.2 trillion of which was held by MMFs that invest exclusively in government and treasury debt.[94]

The security typically associated with MMF investing is as much a function of government regulation as industry advertising. The Investment Company Act[95] requires most investment funds to calculate the current net asset value of each share in the fund with reference to its market value. If market valuations are not available, firms must complete their own valuation in good faith.[96] Under rule 2a-7, MMFs are exempt from these requirements.[97] Money market funds may instead use what is known as the amortization cost method of valuation, which allows MMFs to maintain a stable valuation of $1/share in a manner akin to a deposit bank account.[98] Coupled with this exemption, however, rule 2a-7 imposes strict parameters on the maturity, liquidity, and credit quality of

92. *See Money Market Funds*, U.S. Sec. and Exchange Comm. (Nov. 3, 2016), http://www.sec.gov/spotlight/money-market.shtml [http://perma.cc/5ZGJ-RUMY].

93. *See* Jonathan R. Macey, *Reducing Systemic Risk: The Role of Money Market Mutual Funds as Substitutes for Federally Insured Bank Deposits* 3–8 (Yale Law Sch. Faculty Scholarship Series, Research Paper No. 422, 2011).

94. Division of Inv. Mgmt., *Money Market Fund Statistics*, U.S. SEC. & EXCHANGE COMM. 2 (June 15, 2017), http://www.sec.gov/divisions/investment/mmf-statistics/mmf-2017-5.pdf [http://perma.cc/S7YB-5MQU].

95. 17 C.F.R. pt. 270, *amended by* Pub. L. No. 112–90 (Jan. 3, 2012).

96. Division of Inv. Mgmt., *Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies,* U.S. SEC. & EXCHANGE COMM. (July 31, 2015), http://www.sec.gov/divisions/investment/icvaluation.htm [http://perma.cc/99E8-DQH5].

97. *Id.*

98. For further details on amortized cost and MMF valuation generally, see INV. COMPANY INST., PRICING OF U.S. MONEY MARKET FUNDS (2011), http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf [http://perma.cc/Z678-28JG].

the assets that MMFs may hold.[99] As with most regulatory references to CRAs, those in rule 2a-7 thus offered the SEC a convenient shorthand for the safety and security the regulator aimed to safeguard.

The first reference to credit ratings appeared in rule 2a-7 in 1983.[100] In Investment Company Act Release No. 13380, "Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies," the SEC restricted MMFs to investing in dollar-denominated instruments that the fund's board of directors "determines present minimal credit risks and which are of 'high quality' as determined by any major rating service."[101] As the Release explains, the reference to credit ratings was a belt-and-suspenders measure: the SEC wanted the quality of the MMF's investments to be subject to board review, but also the oversight of an independent third party.[102] The SEC had received "conflicting comments" regarding the proposed standards from industry participants, with some arguing that the rule should rely entirely on the board of directors' opinion, and others contending that the rule should compel MMFs to rely on CRAs alone.[103] In the final rule, the SEC chose both.[104]

It bears noting that § 939A of Dodd-Frank was not the first time that the SEC had considered the wisdom of referring to credit ratings in its regulations. The SEC solicited comments concerning the role of NRSROs in its regulations

---

99. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-782, ACTION NEEDED TO IMPROVE RATING AGENCY REGISTRATION PROGRAM AND PERFORMANCE-RELATED DISCLOSURES 49 (Sept. 2010).

100. Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), 48 Fed. Reg. 32,555, 32,566 (July 18, 1983) (to be codified at 17 C.F.R pt. 270).

101. *Id.*

102. *Id.* at 32560.

103. *Id.*

104. *Id.* ("The Commission believes that both tests are significant and, therefore, has retained both in the rule. The requirement that a security have a high quality rating provides protection by ensuring input into the quality determination by an outside source. However, the mere fact that an instrument has or would receive a high quality rating may not be sufficient to ensure stability. The Commission believes that the instrument must be evaluated for the credit risk that it presents to the particular fund at that time in light of the risks attendant to the use of amortized cost valuation or penny-rounding. Moreover, the board may look at some aspects when evaluating the risk of an investment that would not be considered by the rating services.") Providing further guidance concerning what would constitute a "major rating service," the SEC cites Standard & Poor's, Moody's, and Fitch by name. In a footnote, it is careful to add, "The Commission does not intend to prescribe that the ratings must come only from one of these three services." *Id.* at 32561 n.33.

in 2003[105] and 2008.[106] After taking little action in 2003, the SEC returned to the subject just five years later in part due to findings from its Office of Compliance Inspections and Examination (OCIE) that funds' compliance with their duty to assess the safety and security of fund investments was worryingly variable.[107] The Commission took no enforcement actions in response to the findings.

In 2009, the SEC adopted a portion of the amendments proposed in its 2008 consultation.[108] With regard to rule 2a-7, the SEC eliminated a provision barring MMFs from investing in asset-backed securities that had not received a credit rating. The SEC made no other modifications to rule 2a-7's references to NRSROs.[109] Not only had most respondents to the consultation opposed removing the references, an OCIE report had also emphasized that "the proposed rule [to remove certain references to NRSROs] eliminated the floor . . . that NRSRO references provided and it was unclear how, if at all, the standard for eligible securities under the proposed rule would ensure that money market funds continued to invest only in securities of the highest credit quality."[110]

With the passage of § 939A, Congress overruled the SEC's decision to retain such references, leaving to the SEC the task of determining "how, if at all" to ensure that MMFs continued to invest in high-credit-quality securities without referring to credit ratings. During the five-year process of proposed and re-proposed rules that followed, the SEC sought to meet Congress's mandate without undermining the rationales that had persuaded it to retain rule 2a-7's references to NRSRO credit ratings just two years prior. Striking this balance proved difficult.

1. The First Proposal

In March 2011, the SEC solicited comments on proposed amendments to rule 2a-7 that would bring the provision into compliance with § 939A. The amendments addressed five elements of the rule. Three are particularly germane to this analysis and, to facilitate tracking the amendment process over time, will structure the discussion that follows: (1) amendments to the criteria for determining whether a security is an "eligible security" for investment ("eligibility"),

105. Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Investment Company Act Release No. 26066 (June 4, 2003), 68 Fed. Reg. 35,258 (June 12, 2003).

106. References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28327 (July 1, 2008), 73 Fed. Reg. 40,124 (July 11, 2008).

107. GAO-10-782, *supra* note 99, at 53–56.

108. References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 Fed. Reg. 12,896, 12,896-97 (proposed Mar. 3, 2011) (to be codified at 17 C.F.R. pts. 239, 270, 274).

109. *Id.*

110. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 99, at 55.

(2) amendments concerning MMFs' monitoring of investments for adverse credit events ("monitoring"), and (3) amendments to the quantitative and qualitative assessments MMFs must complete in order to predict portfolio performance during periods of substantial volatility ("stress testing").

i. Eligibility

In general, rule 2a-7 requires MMFs to invest exclusively in securities that are liquid, short-term, and of high credit quality. Prior to the SEC's revisions to comply with § 939A, credit ratings were a part of these eligibility criteria. Rule 2a-7 defined an "eligible security" as "A Rated Security[111] with a remaining maturity of 397 calendar days or less that has received a rating from the Requisite NRSROs[112] in one of the two highest short-term rating categories," or an unrated security of comparable quality.[113] Two further conditions for determining eligibility bear noting.

First, under the header "Portfolio Quality—general," rule 2a-7 mandated that the MMF's board of directors determine that all securities purchased by the fund posed "minimal credit risks" based on a set of factors that included, but

---

111. A "Rated Security" is defined as either (i) a security that "has received a short-term rating from a Designated NRSRO, or has been issued by an issuer that has received a short-term rating from a Designated NRSRO with respect to a class of debt obligations (or any debt obligation within that class)"; (ii) a security "subject to a Guarantee that has received a short-term rating from a Designated NRSRO"; or (iii) a security that is not a Rated Security but "is subject to an external credit support agreement (including an arrangement by which the security has become a Refunded Security) that was not in effect when the security was assigned its rating, unless the security has received a short-term rating reflecting the existence of the credit support agreement." 17 C.F.R. § 270.2a-7(a)(21) (2011).

112. A "Requisite NRSRO" is defined as:

> (i) Any two Designated NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or
> (ii) If only one Designated NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund acquires the security, that Designated NRSRO.
> 17 C.F.R. § 270.2a-7(a)(23). "Designated NRSRO," in turn, means any one of at least four nationally recognized statistical rating organizations as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(62)) that:
> (i) The money market fund's board of directors:
> (A) Has designated as an NRSRO whose credit ratings . . . will be used by the fund to determine whether a security is an Eligible Security; and
> (B) Determines at least once each calendar year issues credit ratings that are sufficiently reliable for such use . . . ."

17 C.F.R. § 270.2a-7(a)(11).

113. 17 C.F.R. § 270.2a-7(a)(12).

could not exclusively rely upon, credit ratings.[114] Second, rule 2a-7 permitted MMFs to invest a maximum of three percent of the fund's total assets in "Second Tier Securities."[115] The rule defined a "second tier security" as "any Eligible Security that is not a First Tier Security,"[116] meaning any security that is not (i) "a Rated Security that has received a short-term rating from the Requisite NRSROs in the highest short-term rating category for debt obligations"; (ii) an "Unrated Security that is of comparable quality to a security meeting the requirements for a Rated Security," as determined by the MMF's board; (iii) a security issued by a registered investment company that is a MMF; or (iv) a government security.[117]

In the March 2011 proposal, the SEC suggested substituting the reference to credit ratings in its definition of "eligible security" with a mandatory two-step eligibility analysis. First, the MMF's board (or its delegate) would assess whether the security "presents minimal credit risks," a phrase that would remain undefined but "must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations."[118] If the security cleared this hurdle, the MMF's board would then determine whether the security was a first or second tier security. "Second tier" would still be defined as an eligible security that is not a first tier security. However, the SEC proposed to redefine "first tier" such that MMF boards would be required to conclude that the issuer of the security has the "highest capacity to meet its short-term financial obligations."[119] All references to "designated NRSRO," "rated security," "requisite NRSRO," and "unrated security" would be removed in the process of making these amendments.[120]

In a July 2011 report, the SEC nonetheless explained that its proposed standard for first tier securities "would be similar to the credit quality standards that have been articulated by the credit rating agencies."[121] Indeed, a footnote in

---

114. *See* 17 C.F.R. § 270.2a-7(c)(3) ("The money market fund shall limit its portfolio investments to those United States Dollar-Denominated securities that the fund's board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by a Designated NRSRO) and that are at the time of Acquisition Eligible Securities.").

115. 17 C.F.R. § 270.2a-7(c)(3)(ii).

116. 17 C.F.R. § 270.2a-7(a)(24).

117. 17 C.F.R. § 270.2a-7(a)(14).

118. References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 Fed. Reg. at 12,898.

119. *Id*. at 12898.

120. *Id.*

121. U.S. SEC. & EXCH. COMM'N, REPORT ON REVIEW OF RELIANCE ON CREDIT RATINGS (2011), http://www.sec.gov/files/939astudy.pdf [http://perma.cc/9XYL-KN9C].

the proposal explicitly cites the scoring systems of S&P, Moody's, and Fitch.[122] Summarizing the proposed revisions to its eligibility standards, the SEC described the changes as substituting the current "objective standard" for a standard that would "require a subjective determination of both eligible securities and first tier securities" by the MMF's board.[123]

ii. Monitoring

Under the heading of "Downgrades, Defaults and Other Events,"[124] rule 2a-7 had mandated that an MMF's board "reassess promptly" whether a portfolio security continued to present "minimal credit risks" if the security, (1) if rated, had been downgraded from the first or second tier of the CRA's scoring system or, (2) if unrated, no longer presented comparable risks as a security rated as first or second tier.[125]

Instead of utilizing credit rating downgrades, the SEC proposed that MMF boards would be required to revisit their determination that a given investment posed minimal credit risks "in the event the money market fund's adviser . . . becomes aware of any credible information . . . that suggests that the security is no longer a first tier security or a second tier security."[126] Much as with its proposed amendments to eligibility, however, the use of credit ratings would by no means be forbidden. "Credible information," the SEC noted, could include a rating downgrade.[127]

iii. Stress Testing

Rule 2a-7 required MMFs to maintain written procedures providing for periodic tests assessing the fund's ability to maintain a stable net asset value of one dollar per share based upon hypothetical events that had to "include, but are not limited to, a change in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on portfolio securities, and the widening or narrowing of spreads between yields on an appropriate benchmark the fund has selected."[128] The SEC's proposed amendment was straightforward: rather than assessing the effect of a "downgrade," stress tests would have to in-

122. References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 Fed. Reg. at 12,898 n.29.

123. *Id.* at 12899.

124. 17 C.F.R. § 270.2a-7(c)(7) (2011).

125. 17 C.F.R. § 270.2a-7(c)(7)(i)(A)(1-2).

126. References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 Fed. Reg. at 12,900.

127. *Id.* at 12,905 ("[A] fund could treat a downgrade as a credit event that might adversely affect a portfolio security.").

128. 17 C.F.R. § 270.2a-7(c)(10)(v)(A).

clude "a hypothetical event" that involves "an adverse change in the ability of a portfolio security issuer to meet its short-term financial obligations."[129] The 2011 proposal notes that this hypothetical event is "designed to have a similar impact on a money market fund's portfolio" as a ratings downgrade."[130]

2. The Re-Proposal

The SEC returned to rule 2a-7 in June 2013 without having adopted or rejected any of its proposed amendments set out in 2011. The 2013 proposals, however, had a different ambition altogether. Rather than bringing the SEC into compliance with § 939A, the SEC detailed sweeping reforms addressing the resiliency of MMFs generally. Indeed, the SEC refers to § 939A once over the course of the document's 698 pages, noting that "we are not rescinding our outstanding 2011 proposal to remove references to credit ratings," and "intend[] to address this matter at another time," adding that "we welcome additional comments" in the meantime.[131] With one exception, additional comments were not forthcoming.[132] The SEC returned to § 939A in July 2014.

i. Eligibility

Many of the comments the SEC received addressing the 2011 proposals objected to the mooted two-step eligibility analysis. In particular, commenters were concerned that neither they nor the SEC would be able to differentiate between first and second tier securities, nor between securities that met the standards for "minimal credit risk" and "first tier."[133]

The 2014 re-proposal responded to these comments by offering to dispense with the two-tiered framework entirely. Rather than categorizing an investment as first or second tier, the SEC proposed that funds could look to the same (undefined) set of factors they used when assessing whether a security posed "minimal credit risks." Under the re-proposed amendment, an "eligible security"

---

129. References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 Fed. Reg. at 12,900.

130. *Id.*

131. Money Market Fund Reform: Amendments to Form PF, 78 Fed. Reg. 36,834, 36,849 (June 19, 2013) (to be codified at 17 C.F.R. pts. 210, 230, 239, 270, 274, 279).

132. *See Comments on Proposed Rule*, U.S. SEC. & EXCHANGE COMMISSION (Oct. 21, 2014), http://www.sec.gov/comments/s7-07-11/s70711.shtml [http://perma.cc/KLX8-N52G].

133. *See, e.g.*, Committee on Investment Management Regulation, Comment Letter on Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule 5–6 (Oct. 14, 2014), http://www.sec.gov/comments/s7-07-11/s70711-44.pdf [http://perma.cc/P8K3-RWC5].

would be a security "[w]ith a remaining maturity of 397 calendar days or less that the fund's board of directors determines presents minimal credit risks, which determination must include a finding that the security's issuer has an exceptionally strong capacity to meet its short-term financial obligations."[134]

The SEC acknowledged apprehensions that MMF directors may take advantage of the amendment in order to invest in a greater proportion of higher yielding, formerly "second tier" securities than the maximum of three percent of total assets permitted under the prior rule.[135] The SEC responded that the novel "exceptionally strong capacity" requirement should provide an adequate check.[136] The "exceptionally strong capacity" standard, the Commission noted, "is designed to preserve the current degree of risk limitation in rule 2a-7 without reference to credit ratings."[137] To illustrate which securities would meet the new "exceptionally strong capacity" standard, the SEC cited the ratings definitions of Fitch, Moody's, and S&P.[138]

Requesting comment on this approach to eligibility determinations, the SEC asked whether commenters believed there was an "alternative standard for making credit quality determinations that is more objective than the reproposed standard," adding that "no commenters provided suggestions when we sought comment in the 2011 proposal."[139]

ii. Monitoring

Commenters were equally unimpressed with the 2011 proposal's amendments to monitoring requirements. Many argued that the proposed trigger for a credit assessment—"in the event the money market fund's adviser . . . becomes aware of any credible information"[140]—was vague and difficult to administer. Several suggested that the SEC instead require MMFs to perform ongoing monitoring and eliminate the requirement to review investments in response to specific events.[141]

134. Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, 79 Fed. Reg. 47,986, 48,013 (proposed Aug. 14, 2014).

135. *Id.* at 47,990.

136. *Id.*

137. *Id.*

138. *Id.* at 47,989 n.38.

139. *Id.* at 47,990.

140. References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 Fed. Reg. 12,896, 12,900 (proposed Mar. 3, 2011) (to be codified at 17 C.F.R. pts. 239, 270, 274).

141. *See, e.g.*, T. Rowe Price, Comment Letter on References to Credit Ratings in Certain Investment Company Act Rules and Forms 3 (Apr. 25, 2011),

The SEC was persuaded: "[C]onsistent with the approach suggested by a number of commenters, we instead re-propose to require that each money market fund adopt written procedures that require the fund adviser to provide ongoing review of the credit quality of each portfolio security."[142] This ongoing review would determine whether the security continued to present minimal credit risks. As a result, the SEC did not anticipate that the proposal would significantly alter the status quo.[143]

iii. Stress Testing

The 2011 proposal called for MMFs to test the safety of their investments against a "hypothetical event" that involved "an adverse change in the ability of a portfolio security issuer to meet its short-term financial obligations."[144] Here, commenters' objections were more technical. Industry participants argued that in passing § 939A, Congress was not attempting to prohibit references to credit ratings *tout court*, but rather to bar only those references requiring the use of credit ratings to assess creditworthiness. The Dreyfus Corporation, for example, argued that "[t]he fact of a credit rating downgrade and its potential impact on security prices is directly relevant to the stability of money market funds, but not relevant to the standard of the 'use of an assessment of creditworthiness' as provided by Section 939A."[145] Under the requirements of the 2011 proposal, the SEC "would simply require funds to stress test for price declines without attributing them to a credit rating downgrade, which," the Dreyfus comment concluded, "seems nonsensical."[146]

The 2014 re-proposal ignored such attempts to restrict § 939A's reach. Instead, the SEC emphasized that its initial proposal did not set out an exclusive list of hypothetical events. Regulated parties were thus free to "continue to test their portfolios against a potential downgrade or default in addition to any oth-

http://www.sec.gov/comments/s7-07-11/s70711-9.pdf [http://perma.cc/78C6-6XWE].

142. Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, 79 Fed. Reg. at 47,995.

143. *Id.* ("We do not believe that the re-proposal . . . would significantly change current fund practices in monitoring minimal credit risks in the portfolio.").

144. References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 Fed. Reg. at 12,900.

145. Dreyfus Corporation, Comment Letter on References to Credit Ratings in Certain Investment Company Act Rules and Forms 9 n. iv (Apr. 25, 2011), http://www.sec.gov/comments/s7-07-11/s70711-19.pdf [http://perma.cc/JR4F-3PAV].

146. *Id.*

er indication or evidence of credit deterioration they determine appropriate."[147] Indeed, the re-proposal included a downgrade or default as examples of events indicating credit deterioration.[148]

3. The Final Rule

The Commission released its final rule to bring rule 2a-7 into compliance with § 939A in September 2015.

i. Eligibility

Commenters addressing the 2014 re-proposal highlighted several outstanding ambiguities, such as that the new "exceptionally strong" standard would be difficult to differentiate from other factors presumptively included in the requisite "minimal credit risk" assessment.[149] The SEC again agreed and chose to retain only the "minimal credit risk" assessment.[150] It also chose to leave this phrase undefined.[151]

In a bid to retain some "objectivity," however, the Commission codified previous guidance concerning the factors relevant for minimal credit risk assessments.[152] Rule 2a-7's definition for "eligible security" now stipulates that a MMF's assessment of whether a security presents minimal credit risk must include, to the extent appropriate, consideration of the following factors with respect to the security's issuer or guarantor:

> (A) Financial condition; (B) Sources of liquidity; (C) Ability to react to future market-wide and issuer- or guarantor-specific events, including

---

147. Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, 79 Fed. Reg. at 47,996.

148. *Id.* at n.114.

149. *See, e.g.*, Fidelity Investments, Comment Letter on Proposed Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule 3 (Oct. 14, 2014), http://www.sec.gov/comments/s7-07-11/s70711-36.pdf [http://perma.cc/U4E8-2URT] (arguing "[t]he Proposed 'Exceptionally Strong Capacity to Meet its Short-Term Obligations' Standard Introduces Uncertainty Without a Corresponding Benefit" and concluding "the new language is ineffectual").

150. Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, 80 Fed. Reg. 58,124, 58,125 (Sept. 25, 2015) (to be codified at 17 C.F.R. pts. 270, 274).

151. See *id.*

152. The Commission refers to these factors as "objective and verifiable tools" that regulated parties and SEC examiners can "rely on in the absence of NRSRO ratings and which should help to achieve our goal of maintaining a similar degree of credit risk as in current money market fund portfolios." *Id.* at 58,127.

ability to repay debt in a highly adverse situation; and (D) Strength of the issuer or guarantor's industry within the economy and relative to economic trends, and issuer or guarantor's competitive position within its industry.[153]

ii. Monitoring

The final rule adopted the re-proposal's language concerning monitoring verbatim. Under 17 C.F.R. § 270.2a-7(g)(3), MMFs must now maintain written procedures that "require the adviser to provide ongoing review of whether each security (other than a government security) continues to present minimal credit risks." The provision goes on to stipulate that this ongoing review must "[i]nclude an assessment of each security's credit quality" and be based on, inter alia, financial data concerning the issuer of the security or its guarantor.[154]

iii. Stress Testing

The re-proposed stress testing regime elicited little enthusiasm from commenters; however nor was there substantial criticism. The Mutual Fund Directors Forum's comments are indicative, offering a half-hearted note of dissent while cognizant that there was sufficient room in the text to effectively preserve the status quo: "While we agree with previous commenters that retaining the reference to a credit downgrade would be preferable, we believe that the new standard will not significantly change the substance of existing stress tests, and thus do not oppose the proposed amendment."[155]

The SEC described the final rule similarly: "We continue to believe that amending the stress testing provision as proposed will continue to promote effective stress testing while implementing Section 939A of the Dodd-Frank Act."[156] Put differently, the SEC was pleased to technically satisfy Congress's mandate while substantially preserving the status quo ante. As suggested in the re-proposal, § 270.2a-7(g)(8) now requires MMFs to maintain written procedures providing for periodic stress testing "based upon specified hypothetical events that include, but are not limited to: . . . (B) An event indicating or evidencing credit deterioration, such as a downgrade or default of particular port-

---

153. *Id.* at 58,153.

154. 17 C.F.R. § 270.2a-7(g)(3)(i)-(ii) (2011).

155. Mutual Fund Directors Forum, Comment Letter on Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in Money Market Fund Rule 5 (Sept. 14, 2014), http://www.sec.gov/comments/s7-07-11/s70711-46.pdf [http://perma.cc/8RNL-CAVS].

156. Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, 80 Fed. Reg. at 58,133.

folio security positions."[157] This is the sole appearance of the term "downgrade" in rule 2a-7's revised text. All other references to credit ratings have been removed.

III. Analysis

The impetus for § 939A of Dodd-Frank was the belief that investors and regulators had *over*-relied on credit ratings prior to the financial crisis. Section 939A, however, instructs federal agencies to remove "any" reference to credit ratings. At the heart of this Note's critique of § 939A is the inconsistency between Congress's diagnosis and prescription. The latter does not follow from the former because *over*reliance implies that *some* reliance remains appropriate.

Federal agencies have sought to retain discretion to stipulate the appropriate boundaries of this "some" while simultaneously meeting the categorical mandate of § 939A. The preceding Part traced, in neutral terms, the results of this tension. Part III drops the impartiality. Section III.A considers the wisdom of § 939A. I argue that even if one accepts the diagnosis of overreliance—a conclusion of which I am skeptical, but do not dispute for present purposes—§ 939A is unlikely to remedy that ill. Section III.B steps back to consider § 939A in light of Congress's broader ambitions concerning CRA reform. I claim that not only is § 939A unlikely to remedy overreliance, it may also undermine related measures seeking to alleviate conflicts of interest.

A. *Section 939A and Mandatory Self-Reliance*

Among those federal agencies that have reached facial compliance with § 939A, few have sought to uphold anything more than the bare letter of its mandate. Granted, from a certain perspective, § 939A is only about "letters," and to that extent the agencies' implementation could be said to have upheld the provision's spirit as well. Yet if one takes the ambition of § 939A to be more than the mechanical erasure of references to credit ratings—that is, if one takes the diagnosis of overreliance seriously—it is clear that the provision has not been successful. Starting from the discrepancy between Congress's diagnosis and prescription, this Section draws on the preceding empirical review to identify the reasons why. I divide these reasons into "supply" and "demand" factors, the former addressing the design of the amended regulations and their supervision, and the latter concentrating on why regulators and investors utilize credit ratings in the first place.

1. "Supply-Side" Critiques

Perhaps the leading reason why § 939A is unlikely to reduce reliance on CRAs relates to its allotment of regulatory discretion. The measure is profligate

157. 17 C.F.R. § 270.2a-7(g)(8).

where it should have been miserly, and stingy where it should have been generous.

Start with § 939A's profligacy. The provision imposes no restraints on regulators' decisions concerning the replacement text for existing references to credit ratings. Section 939A simply calls for regulators to "substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate."[158] Those tasked with revising the provisions appear to have begun from the premise that what was most "appropriate" was the standard prior to Congress's interference. Put colloquially, it wasn't broke, so they objected to the fix.

The SEC's amendments to rule 2a-7 are indicative. Discussing the (ultimately rejected) "exceptionally strong capacity" standard for eligibility in its 2014 re-proposal, the SEC noted, approvingly, that "the phrase 'strong capacity' reflects the standard that one NRSRO articulates for securities with a second tier rating."[159] Likewise, describing how the Commission expected regulated parties to implement the new stress testing regime, the SEC observed that "a fund adviser's obligation to monitor risks to which the fund is exposed would, as a practical matter, require the adviser to monitor for downgrades by relevant credit rating agencies."[160] The key phrase here is "as a practical matter." Instructed by Congress to devise an "appropriate" alternative to credit ratings, federal agencies took care to ensure that regulated parties could proceed as if the amendments had never occurred; which is to say, relying on credit ratings when and where they saw fit.

Regulators have also used their discretion under § 939A to formulate vague amendments granting them greater enforcement discretion.[161] The four investment eligibility factors that the SEC chose to codify in rule 2a-7 are indicative. These include the investment's financial condition, sources of liquidity, ability to react to future adverse credit events, and the "[s]trength of the issuer or guarantor's industry within the economy and relative to economic trends, and issuer or guarantor's competitive position within its industry."[162] Setting to one side that all of this information is conveyed in a typical CRA report, it is difficult to anticipate how an MMF would demonstrate—if challenged during an inspection or in an enforcement action—the reasonableness of its interpretation of variables as indeterminate as the issuer's industry's strength "relative to economic trends." A similar concern applies to the OCC's standard of "ade-

158. Dodd-Frank, Pub. L. No. 111-203, § 939A(b), 124 Stat. 1376, 1887 (2010).

159. Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, 79 Fed. Reg. 47,986, 47,990 (proposed Aug. 14, 2014).

160. *Id.* at 47,995–96.

161. For those wary of the administrative state, this is of course an ill in and of itself regardless of any negative implications for the efficacy of § 939A.

162. 17 C.F.R. § 270.2a-7(a)(11)(a)-(d).

quate capacity to meet financial commitments."[163] The OCC does provide further guidance in the next sentence of its revised regulation, explaining that "[a]n issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected."[164] But a rough translation of that explanation underscores its inadequacy: regulated parties may demonstrate the debtor's capacity to repay by demonstrating that the debtor can repay.

Though it is hazardous to predict investors' response to indeterminate enforcement, it is at least plausible that the vagueness of the amended text will encourage investors concerned with demonstrating compliance toward the few "objective" sources available. Coupled with regulators' repeated acknowledgments that consulting credit ratings remains wholly appropriate, this may mean investors rely *even more* on CRAs.

Section 939A is also stingy where it should have granted greater discretion. One purported consequence of investors' overreliance on credit ratings is their "herd behavior" in reacting to credit ratings.[165] The expression refers to the destabilizing impact on markets when large numbers of investors respond simultaneously, and identically, to a credit rating announcement for a given issuer or security. The typical analogy likens the behavior to lemmings proceeding over a cliff.[166] Yet § 939A calls for federal agencies to establish "uniform" standards of

---

163. 12 C.F.R. § 28.15(a)(iii) (2014).

164. *Id.*

165. *See, e.g.,* FIN. STABILITY BD., PRINCIPLES FOR REDUCING RELIANCE, *supra* note 15, at 1 (citing pro-cyclicality and herd behavior as consequences of investors' overreliance on credit ratings); Kathleen L. Casey, Commissioner, SEC, Speech at SEC Open Meeting: Removal of Credit Rating References From Exchange Act Rules (Apr. 27, 2011) (including "herding behavior" among the "broad, negative and damaging consequences . . . of hardwiring ratings in our rules" and arguing that understanding and correcting these consequences "is one of the most important lessons from the crisis").

166. *But see* Henry Nichols, *The Truth About Norwegian Lemmings*, BBC (Nov. 21, 2014), http://www.bbc.com/earth/story/20141122-the-truth-about-lemmings [http://perma.cc/M6BF-UR9N] ("Despite what you have heard, lemmings are not stupid, they don't suicidally hurl themselves off cliffs."). A Walt Disney documentary, *White Wilderness*, is partly to blame. Dramatizing the mass suicide, a voice-over informs the viewer: "This is the last chance to turn back, yet over they go, casting themselves bodily out into space." *See White Wilderness*, YOUTUBE (Nov. 15, 2006), http://www.youtube.com/watch?v=xMZlr5Gf9yY [http://perma.cc/4TTT-G2F2]. As it turns out, the lemmings in *White Wilderness* were tipped into the sea from a truck. Those with a soft spot for lemmings are advised to stop viewing at 01:30, although the moderator later notes that the lemmings died due to subsequent drowning rather than the (compelled) leap itself.

credit-worthiness, replicating the ill.[167] Thus, the SEC boasts that codifying the four components of its staff guidance for assessing eligibility under rule 2a-7 will "promote uniform credit quality standards in the absence of specific NRSRO ratings requirements."[168] Similarly, some regulators have met the requirements of § 939A by referring regulated parties to alternative, third party evaluators of creditworthiness. Thus, rather than the lemmings stampeding toward the cliff in response to a CRA report, we can imagine a future where the same occurs in response to, for example, a revision to the country risk classification by the OECD.

By affording discretion where specificity was required, and restraining discretion precisely where a more diverse set of approaches would have been most useful, Congress decreased the likelihood that § 939A would reduce investors' reliance on credit ratings.

2. "Demand-side" critiques

Section 939A is also unlikely to achieve Congress's ambitions because the provision does not grapple with why investors and regulators chose (and continue to choose[169]) to use credit ratings. For regulators, outsourcing the determination of appropriate criteria for creditworthiness to CRAs was not a product of laziness but rather an accurate recognition of private sector expertise. For investors, credit ratings help reduce transaction costs stemming from information asymmetries. Had the drafters of § 939A accounted for these motivations, there is little doubt they would have designed a different measure.

Beginning with the motives of regulators, the revisions to rule 2a-7 once again offer a useful case study. The rule's final text addressing monitoring requirements instructs MMFs to maintain written procedures that "require the adviser to provide ongoing review of whether each security (other than a government security) continues to present minimal credit risks" and stipulates that this review must "[i]nclude an assessment of each security's credit quality."[170] This provision replaces text that required investors to review the creditworthiness of investments in response to specific events, including credit rating downgrades.

167. Dodd-Frank, Pub. L. No. 111-203, § 939A(b), 124 Stat. 1376 (2010) ("In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency . . . .").

168. Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, 80 Fed. Reg. 58,124, 58,127 (Sept. 25, 2015) (to be codified at 17 C.F.R. pts. 270, 274).

169. *See, e.g.*, Jess Cornaggia et al., *Credit Ratings and the Cost of Municipal Financing*, REV. FIN. STUD. (2017) (using a Moody's rating scale recalibration in 2010 to find that investors continue to rely on ratings to assess credit risks).

170. 17 C.F.R. § 270.2a-7(g)(3).

The new text is both more difficult to comply with and less likely to advance the purpose of monitoring. In substituting a set of specific, identifiable variables for indeterminate factors such as continuing to present "minimal credit risks" and strong "credit quality," the revised monitoring requirements encourage MMFs to expand the scope of their analysis such that the signals are more likely to be lost in the noise. Had Congress appreciated that regulatory references to credit ratings reflected an efficient deferral to private sector expertise, it may have also anticipated that regulators would seek to replace references to credit ratings with ambiguous text that permits the same behavior. Indeed, as noted above, the SEC cited investors' capacity to continue consulting credit ratings for monitoring purposes as an advantage of the revised text. Put in somewhat sharper terms, strictly facial compliance with § 939A is a virtue.

Turning to regulated parties, investors use CRAs to mitigate information asymmetries, and more generally, to reduce the transaction costs incurred in collecting information. Granted, Congress does not enact laws solely to advance economic efficiency. A defender of § 939A may further contend that investors proved themselves incapable of self-regulation in 2007, and if increased transaction costs accompany necessary reform, then perhaps that effect is best understood as the overdue compulsory internalization of negative externalities.

On the other hand, if, as the preceding analysis claims, § 939A is unlikely to have a material effect on these externalities and is instead likely to increase costs in the name of superficial compliance, then Congress can and should take investors' complaints into account. Their complaints have, perhaps tactically, focused less on costs and more on Congress's failure to appreciate that many of the services provided by CRAs are difficult for all but the most sophisticated of investors to undertake in-house.[171] Congress is unlikely to wean investors from credit ratings until it can point toward a viable (including cost efficient) alternative.

The "supply" and "demand" oversights of § 939A are specific flaws that follow from Congress's more general failure to appreciate that, in the context of sophisticated financial transactions, self-reliance may be an inefficient ideal. At the very least, the example of § 939A indicates that it cannot be achieved by diktat. Below,[172] I suspend the assumption that the diagnosis of overreliance was accurate. For present purposes, it is sufficient to note that even assuming investors were unduly dependent on credit ratings, proclaiming "thou shalt not" and deferring the remainder to federal agencies was an inadequate response.

171. However, costs have not been entirely ignored. *See, e.g.*, *Oversight of the Credit Rating Agencies Post-Dodd-Frank: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Services*, *supra* note 64 (statement of Gregory W. Smith, General Counsel and Chief Operating Officer, Colorado Public Employees' Retirement Association) (noting in prepared remarks that "identifying cost efficient measures that could comprise a robust, objective evaluation of credit risk remains elusive").

172. *See* Part IV.C, *infra*.

B. Section 939A and Conflicts of Interest

Subtitle C of Dodd-Frank, "Improvements to the Regulation of Credit Rating Agencies," aimed to address both of the principal criticisms of CRAs. The Congressional findings detailed in § 931 thus highlight the "reliance placed on credit ratings by individual and institutional investors and financial regulators," and that, "[i]n certain activities . . . credit rating agencies face conflicts of interest that need to be carefully monitored and that therefore should be addressed explicitly in legislation."[173]

Dodd-Frank includes several measures designed to understand and alleviate these conflicts of interest. Sections 939C-F, for example, require the SEC and Government Accountability Office to study the feasibility of various reforms to CRAs' business model and the broader industry's oligopolistic organization.[174] Section 939F promised to be the most sweeping. It instructs the SEC to study conflicts of interest associated with the rating of structured financial products, and the feasibility of establishing a public utility that would assign a CRA to a given issuer or issuance.[175] To illustrate, in lieu of an issuer selecting Fitch to rate its securities, the issuer would apply to the public utility, which would then assign a qualified CRA to the issuance. At least in theory, Fitch would therefore have less incentive to seek repeat business by issuing an inaccurately favorable rating. Critically, § 939F placed the burden on the SEC to demonstrate why the proposed public utility was *not* necessary, stipulating that the SEC "shall implement the system . . . unless the Commission determines that an alternative system would better serve the public interest and the protection of investors."[176]

SEC staff completed the study mandated by § 939F and provided their recommendations to Congress in December 2012. However, the study's primary recommendation encouraged the SEC (note: not Congress) to "convene a roundtable" to discuss the study and its findings.[177] There is no indication that this roundtable was ever convened, or that the senators calling for a fundamental reorientation of the credit rating industry are particularly concerned about the mooted public utility's quiet death.

The fate of § 939F is interesting in and of itself as a case study in how congressional ambitions may be overcome by industry and bureaucratic inertia. Its greater relevance here, however, relates to the evidence it provides of Congress's willingness to adopt (if not follow through on) drastic measures to mitigate

---

173. Dodd-Frank, Pub. L. No. 111-203, § 931(4), 124 Stat. 1376, 1872 (2010).

174. *Id.* § 939F(C)-(F) at 1888–90.

175. *Id.* § 939F at 1889–90.

176. *Id.* § 939F(d)(1) at 1890.

177. *See* SEC. & EXCH. COMM'N, REPORT TO CONGRESS ON ASSIGNED CREDIT RATINGS 73 (2012), http://www.sec.gov/news/studies/2012/assigned-credit-ratings-study.pdf [http://perma.cc/YHU7-VTNU].

CRAs' conflicts of interest. A majority of the House and Senate was willing to transform the basic operation of the industry in order to combat these perceived failings. In this light, it is all the more striking that § 939A may very well exacerbate conflicts of interest.

The view that CRAs are inherently conflicted is typically premised on some version of the following logic: (1) Much of CRAs' revenues come from fees paid by issuers to obtain credit ratings; (2) issuers enjoy lower borrowing costs when credit ratings are high; (3) CRAs seeking repeat business are therefore disposed to assign a higher credit rating than if this decision had no bearing on future revenues; and, sometimes overlooked, (4) investors will not provide an adequate check on such "rating inflation,"[178] because their investment mandates often stipulate rating floors.[179] Issuers, CRAs, and investors therefore all benefit from inaccurately high ratings—until a default.

Now consider § 939A once more. Credit ratings first appeared in regulations after the 1929 stock market collapse in order to curtail investors' discretion, limiting the investment universe to assets deemed creditworthy by a presumptively objective assessor. Section 939A runs in the opposite direction, calling on investors to exercise greater responsibility by eliminating mandatory consultation of the (no longer presumptively objective) assessors. Sections 939C-F, meanwhile, are premised at least in part on the belief that investors face the same conflicts of interest as issuers and CRAs. They, too, have a vested interest in higher credit ratings. The upshot is an incoherent amalgamation of behavioral theories: investors are foxes for some purposes and hens for others. For the conflicts of interest targeted in Sections 939C-F, investors cannot be trusted. For the overreliance targeted in § 939A, they must be.

The SEC alluded to this tension when discussing its proposal to remove the tiers of eligibility framework from rule 2a-7. It acknowledged that "under the proposed subjective standard, a money market fund board (or its delegate) could disregard a second tier rating in order to invest a larger portion of the fund's portfolio in lower quality securities that it classifies as first tier securi-

178. *See* Patrick Bolton et al., *The Credit Ratings Game*, 67 J. FIN. 85, 86–89 (2012).

179. *See* INT'L ORG. SEC. COMM'NS, GOOD PRACTICES ON REDUCING RELIANCE ON CRAS IN ASSET MANAGEMENT 13–15 (June, 2015), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD488.pdf [http://perma.cc/3K5K-8S7K]. For an insightful and accessible discussion of conflicts of interest in the credit rating industry, see Stephen G. Cecchetti & Kermit L. Schoenholtz, *Credit Ratings and Conflicts of Interest*, MONEY & BANKING (June 6, 2016), http://www.moneyandbanking.com/commentary/2016/6/6/credit-ratings-and-conflicts-of-interest [http://perma.cc/2XH7-VEHE]. *See also* EUR. SEC. & MKTS. AUTH., COMPETITION AND CHOCE IN THE CREDIT RATING INDUSTRY (Dec. 16, 2016), http://www.esma.europa.eu/sites/default/files/library/2016-1662_cra_market_share_calculation.pdf [http://perma.cc/R7WF-UMN5]; Lynn Bai, *On Regulating Conflicts of Interest in the Credit Rating Industry*, 13 LEGISLATION & PUB. POL'Y 253, 253–70 (2010).

ties."[180] In other words, the SEC granted that MMFs face incentives to inflate credit ratings. The Commission never elaborated on this point, and as the final text of rule 2a-7 indicates, the tension did not prove a barrier to dispensing with the tiers of eligibility framework and granting investors greater discretion. The SEC's decision may reflect the blunt mandate of § 939A, or a belief that the benefits from greater investor independence would exceed the potential harms stemming from investor-driven rating inflation. In either case, it appears that § 939A is not just unlikely to fulfill its particular aim of reducing overreliance, it may also undermine Dodd-Frank's attempts to reduce conflicts of interest.

IV. Counterarguments and Paths Forward

This final Part begins, in Section IV.A., by addressing two rebuttals to the criticisms above: first, that the benefits of § 939A exceed its imperfections, and second, that condemnation of § 939A is premature. Finding both arguments wanting, Sections IV.B and IV.C turn to assessing alternatives to the blunt mandate in § 939A. Section IV.B considers the EU's recent attempts to implement the recommendations of the Financial Stability Board. I find that the method, though perhaps not the precise content, of EU provisions may provide a path forward for the U.S. Congress. Section IV.C concludes by exploring what options may be available to policy makers if we suspend the assumption that overreliance is an accurate diagnosis and thus appropriate starting point for reforming the credit ratings industry.

A. *Counterarguments*

Section 939A's defenders may argue that the criticisms leveled in Part III caricature Congress's ambitions. The drafters of Dodd-Frank did not expect every investor—no matter how ill-equipped—to perform all of its own due diligence. Nor did Congress expect that merely by erasing the term "NRSRO" from administrative regulations, issuers and investors would suddenly forsake CRAs or be excused from contracts mandating they rely on credit ratings. This argument contends that Congress's ambition was instead incremental, viewing § 939A as a first step in a long-term project of weaning issuers, regulators, and investors off of entrenched habits. In brief, this first counterargument maintains that the critiques above risk making the perfect the enemy of the good.

The argument falls short because this Note's analysis suggests not just that § 939A is imperfect, but that it is harmful. Without rehearsing the "supply" or "demand" side critiques above, erasing all regulatory references to credit ratings is less likely to reduce overreliance than it is to raise transaction, compliance, and enforcements costs. The net outcome with regard to overreliance is therefore not a small, provisional step forward, but rather a potentially substantial

180. References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 Fed. Reg. 12,896, 12,908 (proposed Mar. 3, 2011) (to be codified at 17 C.F.R. pts. 239, 270, 274).

step backward. With respect to conflicts of interest, § 939A affords greater discretion to the very same investors that Sections 939C-F presume to be incentivized to inflate creditworthiness. The resulting conceptual incoherence has left regulators and investors alike befuddled. Federal agencies have responded with cosmetic amendments that substantially preserve the status quo, albeit with additional enforcement uncertainty and transaction costs. This, too, is a step backward. The counterargument thus falls short even if we accept its central premise: far from making the perfect the enemy of the good, we should be quick to make even the perfect the enemy of the bad.

The second counterargument objects on grounds of ripeness, contending that the criticisms of § 939A above are hasty and lacking in empirical support. When federal agencies have only recently (or in the case of the FDIC, not yet[181]) reached full compliance with the measure, it is premature to call for amendment. As much as patience is a virtue—and accepting that some regulated parties prefer certainty regardless of the regulation's content[182]—this critique is unpersuasive because it asks critics to wait for evidence of § 939A's efficacy that is unlikely to ever arrive.

Consider the next financial crisis. Suppose, first, that the crisis in all relevant respects mirrors that of 2007: credit ratings are revised precipitously from inaccurate highs, investors suffer indiscriminately as the market turns against even creditworthy investments, and Congress again says "never again." Would this prove that § 939A had failed because overreliance on credit ratings continued to plague financial markets? Not necessarily. Briefly put, correlation and causation are exceptionally difficult to distinguish in parsing investment motivations or outcomes.

Suppose that the market tanks once more. This time, despite CRAs again precipitously downgrading securities from inaccurate highs, investors' suffering is highly variable, and Congress now says "mission accomplished." Was § 939A's mission to reduce overreliance actually accomplished? Again, not necessarily. That investors' outcomes diverged does not prove that they were now exercising greater independence in their credit assessments. Proving that it was investors' newfound independence that explained the divergent investment

181. *See supra* pp. 118-20.

182. Alternative currencies and the burgeoning marijuana industry are demonstrative. *See, e.g.*, Trevor Hughes, *Uncertainty Roils American Marijuana Industry over Feared Federal Crackdown*, USA TODAY (Jan. 4, 2018), http://www.usatoday.com/story/news/2018/01/04/uncertainty-roils-american-marijuana-industry-over-feared-federal-crackdown/1004250001 [http://perma.cc/324L-8DUE]; Joseph Young, *Without Unified, Federal Regulations for Digital Currencies, the U.S. Risks Falling Behind*, BITCOIN MAG. (Aug. 1, 2016), http://bitcoinmagazine.com/articles/without-unified-federal-regulations-for-digital-currencies-the-u-s-risks-falling-behind-1470086728 [http://perma.cc/7GNX-MY68].

outcomes would still require isolating the role of credit ratings from all of the various inputs into a given investment decision.[183]

This is not to suggest that Congress should amend or scrap § 939A on the basis of a hunch alone—which is to say, mine, rather than that of its proponents. Instead, it is to recognize that causal claims in this area will always be sketchy. If decisive data is a precondition for revising § 939A, its future is bright indeed.

However, nor should Congress ignore what information is available. Recall that the U.S. was not the only government that sought to reduce reliance on credit ratings after the 2007 crisis. Pursuant to the recommendations of the FSB, the EU has attempted similar reforms.[184] Although its experiences are also not incontrovertible evidence for or against a given approach, and any lessons drawn come with the caveat of *mutatis mutandis*, they do provide a basis for comparison. The following Section focuses on the EU reforms in order to ask whether strategies adopted across the Atlantic may indicate a path forward.

B. The EU Approach

Two words in the FSB's First Principle underlie a key distinction between the U.S. and EU's strategies for reducing reliance on credit ratings: "wherever possible."[185] As noted above, Congress did not include the phrase in Dodd-Frank.[186] The EU favored a less demanding analogue—"where appropriate."[187]

183. And one need not subscribe to legal realist claims to grant that investors, too, are likely swayed as much by what they had for breakfast as purportedly objective inputs such as credit ratings. *But see* William W. Fisher III et al., *Introduction*, *in* AMERICAN LEGAL REALISM vi, xiv (William W. Fisher III et al. eds., 1993) ("The realist credo is often caricatured as the proposition that how a judge decides a case on a given day depends primarily on what he or she had for breakfast.").

184. For a review of post-crisis reforms planned or undertaken across the FSB's membership, see FIN. STABILITY BD., THEMATIC REVIEW ON FSB PRINCIPLES FOR REDUCING RELIANCE ON CREDIT RATINGS, Annex C (May 12, 2004), http://www.fsb.org/wp-content/uploads/r_140512.pdf [http://perma.cc/EKE9-YRBU].

185. In context: "Standard setters and authorities should assess references to credit rating agency ratings in standards, laws and regulations and, *wherever possible*, remove them or replace them by suitable alternative standards of creditworthiness." FIN. STABILITY BD., PRINCIPLES FOR REDUCING RELIANCE, *supra* note 15, at 1 (emphasis added).

186. Note that Congress passed Dodd-Frank several months before the FSB published its "Principles for Reducing Reliance on Credit Ratings." Thus, the claim here is not that Congress ignored international guidance.

187. In context: "Sectoral competent authorities in charge of supervising the entities referred to in the first subparagraph of Article 4(1) shall . . . assess the use of contractual references to credit ratings and, where appropriate, encourage them to mitigate the impact of such references, with a view to reducing sole and mechanistic reliance on credit ratings . . . ." Council Regulation 462/2013, art. 5a, O.J. (L

This Section contends that this two-word distinction is at the heart of a broader divergence between the regulatory strategies adopted in the U.S. and EU. "[W]herever possible" underpins an EU reform program that has been pragmatic, humble, and open to experimentation. Such an approach may offer an attractive and viable alternative to the categorical mandate of § 939A.

As an introduction to the EU's program for reducing reliance—and as an indicator of the EU's comparative amenability to trial and error—note that the EU's Credit Rating Agencies Regulation is currently in its third version. "CRA III," passed in 2013, follows two prior versions of the regulation passed in December 2010 and May 2011. That the EU reform program is not "one and done" no doubt partly reflects particular parliamentary procedures, political conditions, and the independence of its regulatory authorities. Yet the distinction between the EU and U.S. has also been attitudinal. The recitals introducing CRA III, for example, emphasize that although "[i]n the medium term, further action should be evaluated to delete references to credit ratings for regulatory purposes from financial regulation . . . for the time being, credit rating agencies are important participants in the financial markets."[188] The potential for change—"for the time being"—and the need for adaptation in light of experience—"further action should be evaluated"—are central themes throughout the text.

Article 5b of CRA III, "Reliance on credit ratings by the European Supervisory Authorities and the European Systemic Risk Board," begins with a familiarly categorical prohibition: "The European Supervisory Authorities [the European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority] shall not refer to credit ratings in their guidelines, recommendations and draft technical standards . . . ."[189] "Shall not" is where § 939A of Dodd-Frank effectively concludes. Article 5b, by contrast, goes on to relax the mandate with two preconditions to the application of the prohibition. The first is purposive. The EU's categorical "shall not" applies only "where such references have the potential to trigger sole or mechanistic reliance on credit ratings by the competent authorities, the sectoral competent authorities . . . or other financial market participants."[190] The

146) 13; *see also id.* art. 5b ("Accordingly, by 31 December 2013, EBA, EIOPA and ESMA shall review and remove, where appropriate, all such references to credit ratings in existing guidelines and recommendations.").

188. *Id.* recital 8 at 2.

189. *Id.* art. 5b at 13.

190. *Id.* Interestingly, the following clause denies similar discretion to the European Systemic Risk Board (a body charged with macro-prudential oversight). Article 5b(2) instructs that "[t]he European Systemic Risk Board . . . shall not refer to credit ratings in its warnings and recommendations where such references have the potential to trigger sole or mechanistic reliance on credit ratings." *Id.* Thus, with regard to the presumptively highest risk components of financial regulation, the EU adopted a categorical approach.

second precondition is practical: the December 31 deadline for the Supervisory Authorities to remove references to credit ratings applies only "where appropriate."[191]

One might question the wisdom of imposing a mandatory "shall not refer to credit ratings" only to undermine its compulsory force in the succeeding sentences. The best response points to the U.S. experience—that is, to regulatory implementation that upholds the letter but rarely the spirit of the provision. As the SEC noted describing its revisions to the stress testing regime under rule 2a-7, by not barring parties from continuing to consult credit ratings, "[the amending provisions] will continue to promote effective stress testing while implementing Section 939A of the Dodd-Frank Act." Put differently, the status quo ante remains in place, but Congress cannot accuse us of noncompliance.

Consider two further provisions in CRA III that, while more directly addressing CRAs' conflicts of interest, demonstrate the EU's comparative amenability to experimentation. First, Article 8d of CRA III seeks to mitigate conflicts of interest by encouraging greater competition among CRAs. The impetus for the measure is clear: in 2015, Moody's, Fitch, and S&P held 92.85% of the European market for credit ratings.[192] Article 8d provides:

> Where an issuer or a related third party intends to appoint at least two credit rating agencies for the credit rating of the same issuance or entity, the issuer or a related third party shall consider appointing at least one credit rating agency with no more than 10% of the total market share, which can be evaluated by the issuer or a related third party as capable of rating the relevant issuance or entity.[193]

The provision raises textual and practical concerns. Textually, the feeble "shall consider" has all the hallmarks of industry lobbying during the drafting

191. *Id.*

192. EUR. SEC. & MKTS. AUTH., COMPETITION AND CHOICE IN THE CREDIT RATING INDUSTRY 6 (Dec. 16, 2016) http://www.esma.europa.eu/sites/default/files/library/2016-1662_cra_market_share_calculation.pdf [http://perma.cc/7PLH-X82D]. Their market share in the United States was 96.5%. *See* SEC. & EXCH. COMM'N, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 11 (Dec. 2016). Note that industry concentration can cut both ways. Supporting the EU's initiative, an oligopolistic market structure could exacerbate conflicts of interest if the few CRAs in the market become excessively deferential to and aligned with certain issuers. There are no real alternatives available, hence it is in both parties' interests to keep a good thing going. Alternatively, expanding competition could exacerbate conflicts of interest if new competition leads to a race to the bottom, each CRA offering a higher (and more inaccurate) rating than the other. A full analysis of these dynamics is beyond the scope of this Note. Those seeking further information will be well served by ORG. ECON. COOPERATION & DEV., COMPETITION AND CREDIT RATING AGENCIES (2010); EUR. SEC. & MKTS. AUTH., COMPETITION AND CHOICE IN THE CREDIT RATING INDUSTRY (Dec. 16, 2016). Thanks to the editors at YLPR for this insight.

193. Council Regulation 462/2013, art. 8d, O.J. (L146) 18.

process. If the ambition was to mandate reference to a CRA with less market share (provided that CRA is "capable of rating the relevant issuance or entity"), then "shall" would have been adequate. Coupled with "consider," regulated parties are merely obliged to think things over. Practically, as a 2015 report by the European Commission notes, small CRAs "do not (as yet, at least) have sufficient reputation among mainstream market participants for issuers to voluntarily choose them."[194] Investors may also not be able to utilize CRAs with less market share due to stipulations in their investment mandates.[195] The central point here, however, is not whether the proposal in article 8d is guaranteed to succeed but rather how it illustrates the EU's willingness to consider alternative and more nuanced solutions to the perceived ills of the CRA industry.

Second, Article 6b of CRA III stipulates that a CRA may only contract to rate the re-securitizations of a given issuer for a maximum of four years. Excluding scenarios in which at least four CRAs rate more than ten percent of the issuer's outstanding re-securitizations,[196] or where the CRA falls below certain revenue and headcount ceilings,[197] after four years the issuer will be required to select a different CRA.

As explained in the regulation's recitals, mandatory CRA rotation should mitigate the conflicts of interest associated with longstanding relationships between issuers and certain CRAs, diminish the "lock-in" effect, and facilitate the entry of competitor CRAs into the market.[198] The recitals also acknowledge potential concerns with the measure, including increased costs for issuers, diminished expertise among CRAs, and the potential for greater market volatility if the new CRA assigns a different rating than its predecessor.[199] While the EU of

194. EUR. COMM'N, STUDY ON THE STATE OF THE CREDIT RATING MARKET, MARKT/2014/257/F4/ST/OP, 8 (Jan. 2016), http://ec.europa.eu/info/system/files/state-of-credit-rating-market-study-01012016_en.pdf [http://perma.cc/ZB3T -YATJ].

195. *See* SEC. & EXCH. COMM'N, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 21 (Dec. 2013), http://www.sec.gov/files/nrsroannrep1213.pdf [http://perma.cc/ANN9-7Q4L] (noting that a barrier to entry for smaller CRAs is "the minimum ratings requirements specifying the ratings of particular rating agencies in the investment management contracts of institutional fund managers . . ."). An IOSCO report likewise cites one fund manager's investment agreement with a large pension fund. It stipulates, inter alia, that "Securities must be rated either by S&P or Moody's." INT'L ORG. SEC. COMM'NS, GOOD PRACTICES ON REDUCING RELIANCE ON CRAS IN ASSET MANAGEMENT 20 (June 2015), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD488.pdf [http://perma.cc/3K5K-8S7K].

196. Council Regulation 462/2013, *supra* note 187, art. 6b(2)(b) at 15.

197. *Id.* art. 6b(5) at 15.

198. *Id.* recital 11 at 3.

199. *Id.* recital 13 at 3–4.

course expects that the provision's benefits exceed its costs, the recitals indicate a remarkably frank acknowledgment of regulatory uncertainty.

Without wading into whether a U.S. regulator would be wise—or, as a matter of administrative law, permitted—to disclose such uncertainty, the distinction with U.S. practice is clear. It is difficult to imagine Dodd-Frank introducing an analogous reform, such as the public utility envisioned in § 939F, with caveats such as "rotation of credit rating agencies could have a significant impact on the quality and continuity of credit ratings."[200] To be fair, Section 939F does call for a study of the proposed public utility, and instructs that the study consider, inter alia, whether "the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government."[201] Yet just as soon as Congress acknowledged some regulatory uncertainty, it foreclosed the outcome of its requested study, mandating that after the submission of the study, the SEC "shall, by rule . . . establish a system for the assignment" of CRAs.[202] There are clear reasons to question the wisdom of Articles 8d and 6b. My aim in presenting these measures is not to lobby the U.S. Congress to adopt the initiatives verbatim so much as to prompt reflection on its approach to CRA reform.

As a final example, the EU's recently adopted MMF regulation offers a useful counterpoint to the preceding analysis of reforms to rule 2a-7 in the U.S. Seizing on the flexibility of CRA III's "where appropriate," Article 20 of the EU's MMF regulation eschews simple erasure of references to credit ratings, stipulating that "Where a credit rating agency . . . has provided a rating . . . the manager of the MMF may have regard to such rating," provided that the manager does not "solely or mechanistically rely[] on such rating."[203]

Taking a step back, one might argue that what the preceding paragraph describes as CRA III's "flexibility" is merely a positive reformulation of what previous portions of this Note criticized as "ambiguity." For example, mirroring generic allusions to "minimal credit risks" in rule 2a-7, the MMF regulation offers a similarly ill-defined standard of "solely or mechanistically."[204] And much like the 2013 Uniform Agreement between U.S. banking regulators that sought, but largely failed, to clarify the term "investment grade,"[205] the European Su-

200. *Id.* recital 13 at 3.

201. Dodd-Frank, Pub. L. No. 111-203, § 939F(b)(2)(C), 124 Stat. 1376, 1889 (2010).

202. *Id.* § 939F(d)(1) at 1889–90.

203. Council Regulation 2017/1131, art. 20(1), O.J. (L169) 30.

204. Indeed, in consultations prior to the passage of CRA III, the ECB echoed such concerns, noting that because "the FSB itself did not provide any definition of mechanistic reliance . . . the ECB would recommend caution" in using the expression, "as this could prove difficult to apply." Opinion of the European Central Bank on a Proposal for a Regulation Amending Regulation (EC) No 1060/2009, at 4, CON/2012/24 (Apr. 2, 2012).

205. See *supra* pp. 118-20.

pervisory Authorities came together in 2014 in an attempt to define "sole or mechanistic reliance." Their efforts appear equally inadequate: "there is sole or mechanistic reliance on credit ratings (or credit rating outlooks) when an action or omission is the consequence of any type of rule based on credit ratings (or credit rating outlooks) without any discretion."[206]

An important distinction nonetheless remains that justifies the positive connotations of "flexibility." The EU couples CRA III's rule ("shall not") with an interpretive standard ("where appropriate"). What I have described as regulatory flexibility stems from this conjunction. Regulators in the U.S., by contrast, must comply with a rule alone ("remove any reference"), and as a result have manufactured flexibility via facially compliant but functionally insignificant amending language.[207] In sum, the EU approach affords regulators limited discretion; the U.S. approach has induced regulatory bad faith—terms such as "flexibility" and "ambiguity" connote the approval/censure appropriate to this distinction.

To be clear, "fail fast" and "iterate or die" are mantras best left in Silicon Valley. These principles should not—and given the strictures of the Administrative Procedure Act, likely cannot—apply to the regulation of private enterprises that prize legal predictability. Yet nor should the U.S. accept a regulatory model of "one and done." The EU's strategies for CRA reform suggest that text such as "where appropriate" may afford the sort of bounded discretion for regulatory innovation and candidness that § 939A's rigidity precludes. Even granting that some of these distinctions reflect political constraints rather than diverging ambitions, the EU's approach deserves careful consideration.

C. An Alternative Path Forward

This Note joins a venerable line of scholarship in offering a great deal of criticism and relatively few solutions. Articulating a menu of reforms for CRA regulation is well beyond its scope and has been ably attempted elsewhere.[208]

206. EUR. BANKING AUTH. ET AL., MECHANISTIC REFERENCES TO CREDIT RATINGS IN THE ESAS' GUIDELINES AND RECOMMENDATIONS, JC 2014 004 at 8 (Feb. 6, 2014), http://eiopa.europa.eu/Publications/Recommendations/JC_2014_004__Final_Report_Mechanistic_References_to_Credit_Ratings__rect.pdf [http://perma.cc/97NJ-8H25]. The causal analysis required by this definition merits the same critiques levied at § 939A in that it appears to require regulators to determine whether an investor's "action or omission" stemmed from the inclusion of a credit rating in a given rule. The "without any discretion" proviso arguably makes non-compliant regulations easier to identify, but that will depend on how EU regulatory authorities choose to construe the language.

207. That is, insignificant with reference to § 939A's ambitions. The provision may very well be significant with regard to transaction costs and other unintended consequences.

208. For a sample, see Coffee, *supra* note 43; Daniel Indiviglio, *Three Suggestions for Reforming Rating Agencies*, THE ATLANTIC (June 19, 2009); and Alice M. Rivlin &

This Section instead concludes by considering the path forward that may be available if we drop the deference—afforded, albeit grudgingly thus far—to Congress's diagnosis that investors and regulators have placed undue reliance on CRAs. I do not claim that this diagnosis is incorrect so much as imprecise. As a result of this imprecision, however, regulators have begun from an inaccurate starting point and will rely upon a flawed foundation for future reforms.

Overreliance is an inaccurate starting point because it directs legislative and regulatory attention toward a symptom rather than the underlying ill. To see why, assume a market in which investors perform no due diligence whatsoever aside from consulting the credit ratings of S&P, Fitch, and Moody's. If these firms issue a high rating, or revise a rating upward, all investors in the market buy. If they issue a low rating, or revise a rating downward, all investors in the market sell. Investors' decision-making in this hypothetical market is mechanical. To round out the picture, further assume that the investors' mechanistic reliance on credit ratings is mandated by regulatory authorities. Reverse § 939A, in other words, such that investors *cannot* perform their own due diligence and their reliance upon CRAs is not just excessive but exclusive.

If we accept that the general ambition motivating Dodd-Frank's reforms to CRA regulation roughly parallels the mission of the SEC—"to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation"[209]—what is wrong with this hypothetical market? In a word, nothing. So long as the ratings are accurate, investors will be protected; markets will be fair and orderly and efficient; and capital will be allocated to its most effective user. So long as the ratings are accurate, the hypothetical market meets our regulatory ambitions.

A better targeted reform project, premised on a more precise diagnosis, would therefore focus on ensuring that "so long as the ratings are accurate" holds true. Reducing reliance on CRAs may indirectly advance that goal—for example, perhaps striking the NRSRO standard from regulations will encourage new CRAs to enter the market, allowing investors to more readily punish CRAs when their ratings are inaccurate by moving business elsewhere—but it certainly directs scarce regulatory attention away from CRAs and the quality of their ratings. That is to say, away from the underlying ill.

Overreliance also establishes a flawed foundation for future regulatory reforms, first, because it is largely immune to measurement, and second, because it leads to challenging (if not wholly impractical) efforts to mandate self-reliance. Beginning with measurement, regulators cannot isolate the portion of a given investment decision made pursuant to a credit rating. Even the EU's more iterative model must ultimately rely on correlations and market surveys in

John B. Soroushian, *Credit Rating Agency Reform is Incomplete*, BROOKINGS (Mar. 6, 2017).

209. SEC. & EXCH. COMM'N, DRAFT STRATEGIC PLAN FISCAL YEARS 2014-2018, at 1 (2014), http://www.sec.gov/about/sec-strategic-plan-2014-2018-draft.pdf [http://perma.cc/26BG-3YUZ].

order to assess whether its interventions have succeeded.[210] Regulators began the project of reducing reliance on credit ratings with little sense of the scope of the problem; nearly a decade later, they have equally little sense of whether they have addressed it or not.

Turning to mandating self-reliance, overreliance also provides a poor foundation for reform because the public interventions that appear to follow from it are, if not impracticable, at least highly unlikely to succeed. As indicated at the outset of this Note, independence is not necessarily immune to instruction or cultivation. The efficiency and related arguments made throughout nonetheless still apply: even if mandatory self-reliance is not an oxymoron, information- and expertise-intensive financial transactions appear uniquely ill-suited to compulsory independence.[211]

What to do? A decade removed from the financial crisis, now appears an opportune moment to reassess. The Trump Administration has called for a general review of excessive regulation (and likely preordained the review's outcome in describing it as such).[212] The reassessment envisioned here is less concerned with quantity than quality. It will strike no one as revolutionary. Policy makers should simply ask whether, in their understandable haste to ward off the next financial crisis, they developed measures likely to advance that end.

Of course, regulators aspire to greater things than avoiding catastrophe. Yet the worst-case scenario provides an appropriate, and intentionally low, hurdle for the reassessment envisioned here. Recall the question: does this measure aid in warding off the next financial crisis? To the extent that the answer is "no," the appropriate response is obvious. To the extent that the answer is "maybe," it is best to leave the regulation in place. Agencies have no choice but to regulate against uncertainty[213] if their role is to be anything other than custodial (in the sense of cleaning up messes that have already been made) and, given the difficulty of devising and implementing any reform, a presumption in favor of preservation appears appropriate. Finally, to the extent that the answer is "we

210. Succeeded in reducing reliance on CRAs in the first instance, but if one accepts the preceding paragraph's analysis, then measuring success will require the even more difficult determination of whether these measures have caused CRAs to produce more accurate credit ratings.

211. Perhaps finance is not altogether unique, however. We might imagine a similar provision in medicine. Following a spate of doctors providing unduly optimistic assessments of their patients' health, Congress responds by mandating that regulators strike all references to physicians, thereby compelling patients to rely less on physicians' expertise. For everyone that does not hold shares in WebMD, the consequences would be disastrous.

212. *See* Presidential Executive Order on Reducing Regulation and Controlling Regulatory Costs (Jan. 30, 2017), http://www.whitehouse.gov/presidential-actions/presidential-executive-order-reducing-regulation-controlling-regulatory-costs [http://perma.cc/F2MG-GV8L].

213. *See generally* Jerry L. Mashaw, *Law and Engineering: In Search of the Law-Science Problem*, 66 L. & CONTEMP. PROBS. 135 (2003).

cannot know," the presumption should shift in favor of removing the provision.

Conclusion

Dodd-Frank's attempt to reduce regulators and investors' dependence on credit ratings by mandating self-reliance vindicates two familiar ideals in U.S. politics and law. On one hand are the (traditionally Conservative) rugged individualists. They pull themselves up by their own bootstraps; seize their own manifest destiny; and require no third-party support, public or private, to achieve their ambitions. "That government is best which governs least,"[214] summarizes adherents' outlook concerning the appropriate response to overreliance, and their school of thought thus looks favorably on any attempt to stimulate independence from third parties. Section 939A appears to fit the bill.

On the other hand is an equally lauded (traditionally Liberal) ideal of public authority in which government can and should intervene in the private sector in order to mitigate negative externalities; or, failing that, compel private actors to internalize such costs. This perspective envisions a robust role for government in preventing the financial crises that rugged individualists consistently create when left to their own devices. Section 939A appeals just as directly to this ideal.

Dodd-Frank § 939A thus appears to combine two lauded visions of public-private interaction under a banner of "mandatory self-reliance." As a targeted critique of Dodd-Frank, this Note contends that, even assuming the wisdom of the project, § 939A is unlikely to achieve Congress's aims. As a broader comment on securities law, it argues that investors should not be compelled to go it alone.

214. *But see That Government is Best Which Governs Least. (Spurious Quotation)*, MONTICELLO (Aug. 28, 2014), http://www.monticello.org/site/jefferson/government-best-which-governs-least-spurious-quotation [http://perma.cc/XSK2-SRN9].