The Financial CHOICE Bill and the Regulation of Credit Rating Agencies: Opening the Gates for the Gatekeeper

** This is a pre-publication version of this article. The Published version "Daniel Cash 'The Financial CHOICE Bill and the Regulation of Credit Rating Agencies: Opening the Gates for the Gatekeeper' [2017] 20 Financial Regulation International 3" is available via the Financial Regulation International Journal. Details of the Journal can be found at http://www.financialregulationintl.com/

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This article focuses upon the proposed 'Financial CHOICE Act' that is currently ascending through the various stages of the American legislative process, particularly in relation to the potential effect upon the regulation of credit rating agencies. The Bill, which recently passed through the Financial Services Committee with a 34-26 vote and will now ascend to the full House of Representatives, aims to 'create hope and opportunity for investors, consumers, and entrepreneurs by ending bailouts and Too Big To Fail', amongst a host of other aims. However, criticism has already been pouring in for, what is effectively, the proposed destruction of the Dodd-Frank Act of 2010, which was designed to protect the American people from the iniquities of the marketplace. In this article, the specific focus will be upon the relevant sections of the Bill with regards to credit rating agencies because, as will be shown, the agencies have and will cause systemic havoc if left unchecked – the question to be asked is 'does the Bill protect the American people, and society moreover, from the venal credit rating agencies?'

Introduction

In 2010, the U.S. introduced *The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, with the expressed aim of 'promoting the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail',

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to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive practices'[1]. Only seven years later, Republican lawmakers – Jeb Hensarling in particular – have decided that Dodd-Frank has failed in its mission and that there needs to be sweeping reforms established to repeal the 'provisions of the Dodd-Frank Act that make America less prosperous, less stable, and less free'[2]. In this article we will be introduced to the Bill in more detail, in addition to examining its potential for it ever becoming an Act of Law. It is important to note here, before the analysis even begins, that this Bill may never see the light of day as a piece of enacted legislation. It is possible, although some have argued it is more likely probable[3], that the Bill will pass through the House of Representatives but will be dismissed in the Senate, but this should not stop us considering the potential effects of the Bill upon the credit rating industry – as just one acute example – for two reasons: firstly, even though the widely-held belief is that the Bill will not become an Act, it still may do; secondly, it is important in this political environment that we all seek to become proactive in assessing the actions of the leaders in society, particularly in light of the politically volatile environment the West finds itself in post-2016.

So, in light of this approach, the article will seek to understand the components of the Bill that would amend the regulation of the credit rating agencies, because the centralised status of the agencies in the modern economy means that any regulation of them, or indeed mis-regulation, could have dire consequences – a fact proven by the events of 2007/08 in which the rating agencies were universally identified as being central to the collapse[4]. After examining the relevant components of the Bill, the article will endeavour to assess the *reality* of the situation and then transpose the Bill's sentiments onto that understanding – what we will see is a blatant ignorance as to the actual targets of these (deregulatory) reforms, which is particularly dangerous. Ultimately, the article will conclude by assessing the potential effects of the regulation of the rating industry being amended so soon after the Financial Crisis.

[1] *The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* 124 Stat. 1376.
[2] *The Financial CHOICE Act of 2017*.
[3] Democratic Representative Maxine Waters has been quoted as stating that the Bill would be 'dead on arrival' to the Senate. Andrew Soergel 'Financial Choice Act Looms Over Dodd-Frank's Future' [2017] US News (May, 4.).
[4] For one of the most extensive, and indeed scathing accounts of the rating agencies' conduct, see United States Senate, Permanent Subcommittee on Investigations *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (GPO 2011).

The Financial CHOICE Bill

The Financial CHOICE Bill, with 'CHOICE' being an acronym of 'Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs', is the brainchild of a small number of Republican Representatives led by Jeb Hansarling. The general theme of the bill is the widespread repealing of many elements of the Dodd-Frank Act of 2010, with bank stress testing, debit card coverage fees, bailouts, and agency oversight being the clearest targets[5]. The Bill was re-introduced to the Committee only last month, and passed through the Committee stage of proceedings extremely quickly, by a vote of 34 to 26. However, in general terms, the Bill instantly received criticism from Professor John Coffee, who stated in his testimony to the Financial Services Committee that, ultimately, the cumulative effects of the Bill 'will be devastating'[6] if enacted – which is a damning verdict on a piece of legislation so young.

For our purposes, the aims of the Bill with regards to the regulation of the credit rating industry – with which we mean, primarily, the so-called 'Big Three' of Standard & Poor's, Moody's, and Fitch Ratings – are just as telling. One recent news story in the American media discusses how, in the opinion of a former senior credit officer and vice-President at Moody's, the Bill is a 'gift' to the agencies[7], and in analysing the specific sections of the Bill, it is hard to disagree. There are, arguably, four stand-out sections of the Bill that are worth our attention, and it would be prudent to go through them in turn before we assess the potential impact that they would have in the following section.

The first relevant section of the Bill, section 852, seeks to prohibit the Securities and Exchange Commission from 'mandating the specific organisation of the disclosures' of the agencies' rating methodologies. In technical terms, this looks like an attempt to allow agencies scope in how they will disclose their rating methodologies – itself a key factor of

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[5] *The Financial CHOICE Act: Executive Summary*.
[6] John C. Coffee 'Simple Truths For a Complex Financial World' [2017] Testimony before the House Financial Services Committee.
[7] Gretchen Morgenson 'Should Free Markets Govern the Bond Rating Agencies?' [2017] New York Times (May, 5.).

rating agency regulation under Dodd-Frank -, but in reality it releases the agencies from their obligation to release their methodologies at all, as there is no recommended oversight according to the Bill. Next, section 853 concerns the ‘Repeal of Certain Attestation Requirements Relating to Credit Ratings’ which, if we look more closely, mandates that the Bill repeals the requirement that the ‘Chief Executive Officer of an NRSRO (Nationally Recognised Statistical Rating Organisation) attest to its internal controls over processes for determining credit ratings’. In essence, the ability to prosecute the leaders of these organisations would, in foul swoop, be removed. Yet, the Bill goes further by removing the requirement for the NRSRO to disclose whether or not its rating was influenced by ‘business activities’, or whether the rating was at least ‘independent’. We will discuss this issue further in the next section, but this notion of removing the requirement to disclose aspects such as conflicts of interest and independence is nothing short of horrendous. Continuing on this point, section 855 states that an NRSRO’s Chief Credit Officer, not its CEO, may now approve the agency’s procedures and methodologies, which not only removes the potential for liability from the CEO, but places the Chief Credit Officer in a protected position within the walls of their own organisation – the CEOs are the recognisable faces of these agencies, not the CCOs, which make any substantial prosecutions that much more unlikely. Section 856, which aims to repeal a crucial element in this industry, states that people who market or sell products and services for an NRSRO may now provide information to people who are primarily concerned with producing ratings for that NRSRO – essentially, the Bill removes any ‘firewalls’ between the commercial and rating interests of an agency, allowing for bias and influence to affect the rating the agency gives. Finally, in what is a truly incredible move, section 857 repeals the Dodd-Frank regulations concerned with establishing ‘state of mind’ when initiating legal action against the agencies, the mandating of studies on the independence of rating agencies, the requirement to look at alternative business models, the study and establishment of ‘assigned credit ratings’, and last, but certainly not least, the repealing of the rescission of the ‘exemption from expert liability afforded to credit rating agencies’ – effectively, rating agencies can, once again, protect themselves against legal action under the banner of immunity for ‘experts’.

This truly staggering approach to regulating such an industry, an industry which has been *proven* to be unquestionably venal in its approach, is nothing short of reckless. The former credit officer called it a ‘gift’ to the agencies, but it is much more than that. At the end of this article we will discuss what the Bill represents *in reality*, but before we do that it is worth discussing the reality of the situation with regards to rating agencies both before and after the Financial Crisis so that we can properly contextualise the incredible proposals put forward by this Bill.

Reality

The Bill puts forward a vision of rating agencies that is defined by a façade of the agencies being negatively constrained by regulation. However, we do not have to go back far to see the effects of leaving the rating agencies unregulated. The ratings industry as we know it today was only formally regulated from 2005/6, with the *Credit Rating Agency Duopoly Relief Act of 2005* and the *Credit Rating Agency Reform Act of 2006*[8], this in spite of the fact that the two leading agencies – S&P and Moody's – are over a century old. Prior to these Acts, the only formal regulation was the SEC's facilitation of the agencies' expansion in 1975 with the adoption of various industry-rules and, eventually, the coveted NRSRO designation[9]. This lack of regulation, when considered against the backdrop of the securities boom in the early 2000s[10], allowed for the agencies to assume a central position within the mortgage-backed securities market and peddle their services to the highest bidder. This article will not go into extensive detail regarding this era in the rating agencies' existence, mostly because it is extremely extensive and has been well covered in the literature[11], but recent settlements between the leading agencies and the US Department of Justice (DoJ), together with actions taken by the SEC, can provide us with the *proof* that the Bill is not considering the reality of the situation.

[8] *The Credit Rating Agency Duopoly Relief Act of 2005* H.R. 2990; *The Credit Rating Agency Reform Act of 2006* Pub. L. 109-291, 120 Stat. 1327.
[9] The term was declared by the SEC in the amendments to Rule 15c3-1, see *Notice of Revision Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934,* Release No. 34-10, 525, 1973 SEC LEXIS 2309 (Nov. 29, 1973).
[10] The Securities Industry and Financial Markets Authority *Statistics: US ABS Issuance and Outstanding (1985 to 2016)* (SIFMA 2016).
[11] Again, the U.S. Senate's investigation is an exceptional account of rating agency transgressions during that era, see US Senate (n 4).

In 2015, the DoJ settled with S&P for a grand total of $1.375 billion for consciously engaging in a 'scheme to defraud investors in structured finance products'[12]. This was, for the most part, in relation to the actions of S&P with regards to its involvement in rating, and in some cases even establishing 'structured investment vehicles', which as entities sought to sell stakes in securities but lasted no longer than a few months, causing massive institutional investors to lose billions of dollars in the process[13]. The agency admitted to this, and had also been banned for the period of one year for engaging in similar activities as late as 2012, in which they were *consciously* releasing misinformation to investors that they *knew* would endanger their investments but enrich the issuers of the debt, who not coincidentally pay the agencies their fees[14]. It is important that we deduce from this the unmistakable realisation that, in light of these catastrophic transgressions, it would be surely foolish to suggest that rating agencies should be relieved of their duties to disclose how they arrive at a certain rating, and what influences may have affected that process – yet, the Bill does just that.

In the Senate investigation, the actual processes of the rating agencies were examined in detail. What was found was that the processes established by agencies, namely the famous 'rating committees' that are designed to foster neutrality and independence by way of anonymous votes and other techniques, were actually exposed to the cross-pollination between commercially-interested employees and ratings-interested employees – in direct opposition to the stated policies of the agencies[15] - with one extract from the investigation confirming that rating analysts were being 'out-voted' by 'mystery voters with no "logic-trail" to refer to'[16]. In addition to this, there also exists a symbiotic pressure between the agencies and the issuers of debt with regards to additional services, with the agencies forcing the rated company to purchase additional services via the threat of a downgrade, also known

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[12] Daniel Cash 'Why the U.S. Department of Justice Must Act Against Moody's Corp' [2016] 37 Business Law Review 6.

[13] For the key case with regards to these famous 'SIVs' like Cheyne Finance, see *King County, Washington, and Iowa Student Loan Liquidity Corporation v. IKB Deutsche Industriebank AG, Moody's Investors Service, Inc., The McGraw Hill Companies, Inc., Fitch, Inc., and Morgan Stanley & Co. Incorporated* [2012] 863 F.Supp.2d 288 (May 4).

[14] Securities and Exchange Commission *Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 8A of the Securities Act of 1933 and Sections 15E (d) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order* [2015] Release No. 9705; 74104, File No. 3-16348.

[15] Stefan Trueck and Svetlozar T Rachev *Rating Based Modelling of Credit Risk: Theory and Application of Migration Matrices* (Academic Press 2009) 12.

[16] US Senate (n 4) 294.

as ‘tying’[17], and the opposing pressure that issuers may induce, whereby they would exert pressure for higher ratings based on the continuing purchase of additional services[18]. These dynamics mean that proposing to remove the firewall that is in place to prohibit the cross-pollination of information between commercially-interested employees and ratings-interested employees would surely be foolish. Yet, the Bill does just that.

In the lead up to the settlement between S&P and the DoJ, many questioned why Moody’s was not the target of an identical investigation, because, as with any oligopoly, it is more than likely that the components of that oligopoly will act in exactly the same manner[19]. The reason for this was because under new rules established by Dodd-Frank, one must obtain proof of the agencies’ ‘state of mind’ in order to be successful. In seeking to bring action against S&P, CalPERS, an institutional investor, settled with Fitch Ratings but, crucially, it settled not for money but for documented evidence. It was this evidence, one can safely assume, that led to S&P accepting their fate and deciding that a settlement with the DoJ (and CalPERS) was the most palatable of the options facing them at the time. It was that same evidence that then allowed the DoJ to settle with Moody’s in January 2017 for $864 million, with Moody’s admitting fault – which, in this industry, is a truly extraordinary occurrence – with respect to its failings in managing the ‘firewalls’ within its organisation, and in covertly departing from published rating methodological practices[20]. This mandate of requiring proof of intent ultimately allowed us all to see the *true nature* of these agencies like never before, with both agencies admitting their guilt. It forced the agencies to admit their guilt, rather than initiating their age-old practices of prolonging and constraining legal action. To remove this mandate, with the tangible effects that we witnessed over the last two years, would surely be foolish. Yet, the Bill does just that.

In regards to the target of the Bill, it arguably does not exist. The regulations suggested by the Republican Representatives are simply not appropriate for the agencies as they exist, and this

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[17] Herwig P Langohr and Patricia T Langohr *The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They are Relevant* (John Wiley & Sons 2010) 423.
[18] Carol A Frost ‘Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies’ [2007] 22 Journal of Accounting, Auditing & Finance 480.
[19] Cash (n 12).
[20] Daniel Cash ‘The Conclusion of the Department of Justice’s Investigation into Moody’s: Financial Penalties but No Deterrent’ [2017] 38 Business Law Review 3.

is the only conclusion we can arrive at, simply because the evidence is in front of us. The agencies themselves have admitted to consciously defrauding investors for profit, and to endangering the very fabric of the economy – trust in information. To suggest that these agencies, literally months after they admit to these crimes, should be regulated *less*, is potentially one of the most irresponsible suggestions in recent history.

Conclusion

Ultimately, the Financial CHOICE Bill represents the ideological division that wreaks havoc. There is no one right ideology, but the division for division's sake that is manifested in this ludicrous regulatory proposal is symptomatic of a much larger problem. It is likely that this Bill will never be enacted as a piece of legislation, but the excessive lurching between regulation and deregulation is extremely dangerous for societal progression. Yet, it is very important that we acknowledge the aims of this Bill and counter them as vociferously as possible, because the potential situation should the Bill pass into an Act is extremely frightening. It is frightening because between the Great Depression and the Financial Crisis stood over 70 years of societal development; if this Bill were to be enacted, *it would* facilitate the pilfering of society but, this time, we would have had only a decade to recover – it simply is not long enough. The rates of austerity, suicide, mental illness, homelessness, and poverty, are far too high to sustain another assault, and for this reason, above many other reasons, this Bill *cannot* come to pass.

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