July 19, 2021

Re: Written Testimony of Professor Robert J. Rhee, John H. and Mary Lou Dasburg Professor of Law, University of Florida Levin College of Law, for the hearing entitled “Bond Rating Agencies: Examining the ‘Nationally Recognized’ Statistical Rating Organizations,” on July 21, 2021

Dear Honorable Members of the U.S. House of Representatives, Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets:

Upon your invitation to participate as an expert witness in the above hearing, I provide this written testimony.¹ I respectfully request that you accept this written testimony into the Congressional records.

Introduction

Credit rating agencies are important institutions in the American and global capital markets. The U.S. capital markets are the deepest and most liquid markets, and many American firms are market leaders, including major rating agencies. Although some commentators dismiss the utility of rating agencies, I believe that rating agencies are important and useful. The credit market is enormous, and debt constitutes the largest form of capital. Rating agencies have a basic market utility: They sort and categorize a vast amount of information in the credit market, and this function serves market efficiency.² Efficient information markets do not exist in a state of nature. The sorting and categorization of information promotes efficient allocation of market resources and price discovery. This function is the key public utility of rating agencies

¹ This written testimony and the expected oral testimony on July 21, 2021, are solely mine and do not represent the opinion or position of the University of Florida or the Levin College of Law.

for which they are given regulatory license. The importance of rating agencies is underscored by the fact that they pose a profound problem of public policy.

Rating agencies are important gatekeepers. Aside from regulators and the axial ends of capital transactions (issuers and investors), the key players in machinery of the capital markets are lawyers, bankers, accountants, exchanges, and rating agencies. The systemic failure of any single group of players could trigger a market crisis. For example, the failures of auditors resulted in the accounting scandals of the 1990s, prompting the enactment of the Sarbanes-Oxley Act of 2002. Among the group of key market players, auditors, exchanges, and rating agencies have much more direct connection to the public good. Their roles serve a public function, even as they are private firms seeking profits. They are more like public goods than private transaction advisers such as investment bankers and lawyers. Exchanges and auditors are meaningfully regulated. Like exchanges and auditors, rating agencies ought to be regulated with the primacy of the public interest in mind, even as such entities are privately owned and have real obligation to make profit for owners.

The perceived problems of rating agencies have long percolated. As the American economy and capital markets became more dynamic and complex starting in the 1970s and accelerating in the 1980s and 1990s, rating agencies took on greater importance. Critics have argued that rating agencies have long delivered poor outcomes with little accountability. They point to flawed ratings in cases such as Enron and WorldCom. More conclusively, critics point to the failures of rating agencies during the financial crisis of 2008. No one can seriously question this narrative for it is history now. If rating agencies had performed properly, the financial crisis would not have happened. This statement is not intended to assign a greater quantum of blame on rating industry in relation to, say, banks and broker-dealers. The point is simpler: In the chain of causality and counterfactuals, rating agencies were the final gatekeepers before “toxic” ABS/MBS and CDO securities could be released into the capital markets. The deals could have stopped at the conference rooms of credit committees, but they were not.

The United States and the world cannot afford another financial crisis for more reasons than money and markets. History has repeatedly shown that because the credit market is so consequential for sovereigns, governmental bodies, and corporations, major disturbances therein have profound consequences on economies, nations, and societies. The consequences of the financial crisis of 2008 still reverberate. We must also consider the real possibility that another systemic failure of rating agencies could interact with the post-Covid-19 world.

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The proper functioning of rating agencies is not only a matter of markets and money. It is a matter of national security. Economic stability is a matter of national security. History has repeatedly shown that instability in the credit market can result in social instability and mass hardship. No country is immune: America, Western Europe, East Asia, and emerging economies. Due to many factors including the Covid-19 pandemic, countries are more brittle and vulnerable than before. For all its past and current flaws, the U.S. financial services industry still holds in trust the largest, most liquid capital market. Good governance should be a global competitive advantage. The systemic mishaps, misdeeds and misjudgments of the financial crisis of 2008 have not only damaged this industry’s reputation capital, but also raised questions about the American model of economic organization and capitalism both internally and globally. This scrutiny is not undeserved. There is again a competition for ideas about political and economic organization. It is clear that we can ill afford another financial crisis brought about by mishaps, misdeeds and misjudgments among financial services firms and the markets they hold in trust.

Since the financial crisis of 2008, there has been modest reforms. Past reforms have been modeled on a well-worn regulatory template: registration and disclosure. This regulatory philosophy works well for the issuance of securities and regulation of certain market actors. However, due to the unique configuration of the rating industry, the application of this template largely avoids confronting the core problems.

**Fundamental Problems of the Credit Rating Industry**

A survey of the scholarly literature shows a strong line of thought that the problems of the credit rating industry stem from several compounding factors.

First, many commentators have identified the issuer-pay model of fees where the corporate issuer pays the rating agency. This problem was also identified for study in the Dodd-Frank Act. The built-in conflict of interest is obvious. Issuers prefer higher ratings since it would reduce the cost of debt and increase the marketability of the issue. The concern is the possibility of “rate shopping” by issuers and structural bias by rating agencies.\(^5\)

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\(^5\) Some defenders of rating agencies may argue that the issuer-pay model is functionally the same compensation model for lawyers, bankers, and auditors, who are also paid by their client companies. This is an imprecise analogy. Lawyers and auditors are governed by professional societies where high professional and ethical standards have long been internalized. The Dodd-Frank Act § 939E requires a study on the creation of an independent professional society like lawyers and auditors. A study was performed, but it was inconclusive. *Credit Rating Analysts: Views Varied on Merits of a Professional Organization, but Creating One Now Viewed as Premature*, U.S. Government Accountability Office (July 2015). With respect to a comparison to auditors, after the Sarbanes-Oxley Act of 2002, auditors are more closely regulated, including prohibitions that constrain their business prospects and models. 15 U.S.C. § 78j-1(g) (“it shall be unlawful for a registered public accounting firm . . . that performs for any issuer any audit . . . to provide to that issuer, contemporaneously with the audit, any non-audit service”). With
Second, many commentators have identified the industry concentration where there are two dominant rating agencies plus another major player. These three rating agencies have always accounting for more than 90 percent of all ratings and revenues. The industry is a “duopoly plus” or more generously an oligopoly. A review of the SEC’s latest annual report on rating agencies show that nothing has changed with respect to basic characteristics of market concentration.6

Many commentators have argued that these two dominant factors compound to produce bad outcomes. The rating industry is not competitive. Three major players dominate the market. This fact alone is not antithetical to positive competition. But rating agencies vie for business in which issuers and bankers prefer higher ratings and there is a common practice is to get more than one rating. Few independent industry observers or academics, I believe, would look at this configuration in the abstract and conclude that such an industry would be optimized for proper incentives and peak performance. The Congressional findings in the Dodd-Frank Act § 931 support this view. Empirical experience of the financial crisis of 2008 and other instances of rating failures has conclusively shown that these concerns are real.

The nature of competition is sometimes misunderstood. We occasionally see calls to qualify more NRSROs or easing the barrier to entry for NRSRO status on the premise that increasing the number of qualified NRSROs should elicit greater competition. But this idea as a policy end is flawed. Competition in the abstract is not inherently good. Numerosity of competitors does not automatically translate into good policy end. Many rating agencies vying for deals under the issuer-pay model may result in a classic “race to the bottom” where each firm seeks to ratchet up ratings for the possibility of getting the deal. This is simply the dynamics of firm profit maximization. Under the right conditions, fewer competitors may engage in robust competition toward a good policy

6 For all practical purposes, little has changed in these matters since the immediate fallout of the financial crisis of 2008 and the enactment of the Dodd-Frank Act and present day. In December 2012, the SEC reported the following: (1) nine NRSROs; (2) the three largest accounted for 96.4% of all outstanding credit ratings; (3) almost 99% of credit ratings were issued under the issuer-pay model. Annual Report on Nationally Recognized Statistical Rating Organizations, U.S. Securities and Exchange Commission, at pp. 4, 6 (Dec. 2012). In December 2020, the SEC reported the following: (1) nine NRSROs; (2) the three largest accounted for 95.1% of all outstanding credit ratings; (3) the larger NRSROs accounted for approximately 93%-95% of revenue, meaning the issuer-pay model not including the issuer-pay models of smaller NRSROs. Annual Report on Nationally Recognized Statistical Rating Organizations, U.S. Securities and Exchange Commission, at pp. 2, 11, 14 (Dec. 2020).
end. Consider the Super Bowl or the World Series. There are only two competitors, but no one would say that these matches lack for competitive vigor toward a good end.

The policy end should be a competition in which there is a “race to the top.” The policy end should be a vigorous competition for the most accurate, bias-free ratings. Competitiveness depends less on the number of NRSROs—and instead on the right incentives. All NRSROs should be incentivized to provide the most accurate, bias-free ratings. These incentives are currently not robust. This conclusion is supported by the empirical evidence of past history and the Congressional findings in Dodd-Frank.

**Current Regulatory Regime and the Need for More Regulations**

Commentators have documented the long relationship between the SEC and rating agencies. I briefly highlight only the most recent main developments.

The Credit Rating Agency Reform Act of 2006 required the registration of NRSROs and imposes disclosure requirements related to the issuance of credit ratings. It also requires the SEC to provide annual reports on the state of the credit rating industry.

The Dodd-Frank Act moved the needle in several ways. Section 932 gives the SEC broader powers to regulate rating agencies including matters related to transparency, internal controls, methodologies, and conflict of interest, and created the Office of Credit Ratings inside the SEC to centralize these functions. Section 933 makes the legal liability of rating agencies under federal securities law coterminous with public accounting firm or a securities analyst and clarifies that the state of mind is satisfied when “the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation . . . or to obtain reasonable verification of such factual elements.” Section 939 requires the removal of references to credit ratings, thus purporting to reduces the benefit of “regulatory license” given to rating agencies, and Section 939A ordered the SEC to review the reliance on credit ratings. Sections 939D and 939F require studies of alternative compensation models.

Pursuant to these statutes, the SEC promulgated rules on procedures, standards for registration, and disclosures in Rule 17g-1 to 17-10. I note that Rule 17g-5 deals with “conflict of interest.” But this rule deals with firm- and individual-level conflict of interest (e.g., members of the credit committee lacking independence due to material interests in the issuer). It does not remedy the systemic, structural conflict of interest inherent in the issuer-pay model. This conflict of interest is at the industry level and exists still.
The above reforms have incrementally moved the needle, but reform is incomplete.\(^7\) They are principally drawn from a common template in federal securities law: registration and disclosure. But they do not fundamentally alter the dynamics of the core problem of issuer-pay and oligopoly. More regulatory reform is needed.

**Specific Comments and Responses to Committee Proposed Legislation**

In a memorandum by FSC Majority Staff to the Committee on Financial Services dated July 16, 2021, the staff identified five draft bills:

1. Commercial Credit Rating Reform Act of 2021 (Sherman)
2. Uniform Treatment of NRSROs Act (Dean)
3. Transparency and Accountability of NRSROs Act
4. Restoring NRSRO Accountability Act
5. Accurate Climate Risk Information Act.

I provide the following comments and responses to each of these proposed bills. Each reform is a positive step toward better regulation of the credit rating industry. One proposal (the Sherman proposed bill) squarely deals with the issuer-pay model.

**1. Commercial Credit Rating Reform Act of 2021 (Sherman)**

This proposed bill represents a continuation of a line of thought in the Dodd-Frank Act. At one time in the legislative process, the Dodd-Frank as passed by the Senate with supermajority support contained a mandated scheme (the Franken-Wicker amendment) in which an independent credit rating agency board would assign randomly assign rating agencies to provide credit ratings, thus removing the rating-shopping and issuer-bias incentives. These provisions from the final Dodd-Frank Act. The statute instead required studies of alternative compensation models. These studies were conducted,\(^8\) but ultimately the SEC did not implement the idea.

The proposed Sherman bill seeks to revive the concept of altering the industry compensation model. It establishes a “Credit Rating Agency Board,” the majority composed from the investor industry. It requires that a corporate issuer “may not request a credit rating from” an NRSRO but instead “shall submit a request for a credit rating from the Board.” The Board shall assign the engagement per “either a lottery or blind rotating assignment system” with consideration given to certain merit-based

\(^7\) See Alice M. Rivlin & John B. Soroushian, *Credit Rating Agency Reform Is Incomplete*, Brookings Institution (Mar. 6, 2017). Among other things, the authors conclude: “we recommend returning to the use of credit ratings for structured products, but if and only if random assignment is implemented.”

factors such as “how the rated instruments perform . . . the accuracy of the ratings . . . the effectiveness of the methodologies.”

The Sherman bill has much merit. Importantly, it does not envision a pure random lottery system. Otherwise, there would be real drawbacks to the proposal. Purely random assignment may arbitrarily increase or decrease a particular rating agency’s current market share without ability to influence the probability of engagement. It may provide no incentive for effort since the probability of engagement would be decoupled from merit, a situation that may worsen rather than improve the current state. But the Sherman bill avoids these problems by including certain merit-based factors that influence the probability of engagement. The Sherman bill would substantially improve the credit rating industry. It would reduce the poor incentives of the issuer-pay model, which many commentators have identified.

I note one distinction between the current Sherman proposed bill and the former Franken-Wicker amendment (former draft Section 939D). The latter provided: “Nothing in this section shall prohibit an issuer from requesting or receiving additional credit ratings with respect to a debt security, if the initial credit rating is provided in accordance with this section.” There does not appear to be a similar provision in the current Sherman proposed bill. It is common practice for issuers to seek multiple ratings. There may be legitimate reasons for this practice. The possibility of two ratings, one assigned and other chosen, presents several possibilities. One possibility is that it dulls a sharp move away from the issuer-pay model. The potential for industry disruption is lessened. Another possibility is that it sets up an internal competition between two rating agencies engaged by different parties. The longterm dynamics may impact reputation capital and the probability of merit-based engagements. A key unknown is whether the chosen rating agency would be influenced to compete with the assigned rating agency, or whether its incentives are similar to current incentives in the issuer-pay model. The answer may depend on each firm’s cost-benefit analysis of the probability of greater market share under the lottery system.⁹

⁹ I understand that most of the hearing time will be devoted to the proposed bills identified in the Staff memorandum. I respect the Subcommittee’s agenda. I note here briefly that in addition to the thoughtful Sherman proposal, there are other alternative models. In a prior work, I proposed to keep intact the core business model of issuer-pay, thus having the benefit of not fundamentally altering the business model of rating agencies. My proposal calls for a mandatory contribution of certain small portion of annual fees earned (e.g., 5%-10%) toward a compensation pool that is managed by a third-party like the proposed Credit Rating Agency Board. At regular intervals, compensation from this pool (a bonus) would be paid to those rating agencies that have performed the best in terms of accuracy. It is a compensation game where each would seek to eat the lunch of the other. Rating agencies would be forced to compete for accuracy, a race to the top. Participation in this bonus pool would be mandatory by making it a condition of the NRSRO status. No rating agency is entitled to the NRSRO status, and it must quality by meeting all conditions of the regulatory license granted to NRSROs. These conditions and requirements are set by the government, ultimately Congress. This proposal has the benefit of leaving intact the industry model while making at-the-margin changes that encourage positive competition
(2) Uniform Treatment of NRSROs Act (Dean)

This proposed bill requires the Federal Reserve to accept credit rating from any NRSRO if the Federal Reserve “establishes a requirement for an entity, security, or other instrument to carry a minimum credit rating.” It provides an important exception. This rule does not apply if the Federal Reserve, in consultation with the SEC, determines that the NRSRO “is unable to provide reliable and accurate ratings for a particular asset class and that such exclusion is in the public interest.”

The Dean bill provides clarity in situations when the Federal Reserve establishes credit facilities, most likely in emergency or crisis situations. It requires uniform treatment of all borrowers, but perhaps more importantly it gives the Federal Reserve the ultimate discretion. The exception would likely be invoked in situations of emergency or crisis. In times of market turbulence or national emergency, many ordinary “rules of the road” may not or should not apply. For example, in thinking about the financial crisis of 2008, I have argued that ordinary state corporation law of fiduciary duty to shareholders and the law of profit maximization should not apply to director actions in times of a national crisis when corporations have the legal power under state corporation laws to aid the government. This principle should apply in situations like the Covid-19 crisis or other economic disruptions.

In the context of the credit markets, ordinary credit analyses may not be relevant in transitory periods of high uncertainty or exogenous shock where ordinary market values and information signals may not be reliable. Wrong judgments may exacerbate a crisis and may bind regulatory or public remedial actions. In other words, some occasions may be too big to rely on the opinions of just a few private firms with great powers to affect, positively or negatively, a public crisis. In times of market turbulence, the Federal Reserve may serve a mediating role, providing liquidity, capital, and economic and financial coordination. It would be proper for the Federal Reserve to make the ultimate determination of whether the credit ratings are unreliable and the public interest merits an exception.

(3) Transparency and Accountability of NRSROs Act

This proposed bill would require the SEC when it produces a required report to “identify such organization by name.” Since the SEC examines NRSROs and reports on

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deficiencies and compliance failures, this requirement would identify by name the
NRSROs that have significant shortcomings. Currently, the SEC practice is to keep the
names anonymous.\textsuperscript{11} There is no reason for the SEC to provide a shield of anonymity.

This proposed bill would increase accountability by public disclosure of deficient
and noncomplying rating agencies. It does not penalize rating agencies any more than
what the current regulation provides, the ultimate sanction being decertification of the
NRSRO status. The only penalty is the loss of reputation capital. This intangible penalty
would incentivize greater compliance and transparency.

Importantly, this disclosure requirement would impose no regulatory cost on the
industry. It would impose only reputation costs at the individual firm level. These
individual costs are offset by gains achieved by complying firms. This must be so
because the number of credit ratings is an independent variable. In other words, the
costs and benefits at the individual firm level is zero sum because the demand for credit
ratings is unaffected by the imposition of reputation costs at the individual firm level. If
noncompliance matters that much to issuers, they will engage the best complying (or
least delinquent) firms. The regulatory and economic effect on the industry is nil. The
proposed bill is eminently sensible. If certain rating agencies are not in compliance with
the modest rules in place, the public should know.

\textbf{(4) Restoring NRSRO Accountability Act}

This proposed bill would nullify a no-action letter issued by the SEC, which states
that the SEC would not recommend an enforcement action if ABS issuers did not
include NRSRO credit ratings in the registration statement. This proposed bill addresses
an interesting prior history.

Dodd-Frank § 939G legislatively overruled SEC Rule 436(g).\textsuperscript{12} Former SEC Rule
436(g) shielded rating agencies from liability under Section 11 of the Securities Act of
1933, which imposes liability for money damages for material misstatements or
omissions in the registration statement, on among others accountants and other experts
named in the registration statement with their consent.\textsuperscript{13} By legal fiat of the SEC, former

\begin{itemize}
\item \textsuperscript{11} E.g., 2020 Summary Report on Commission Staff’s Examinations of Each Nationally Recognized Statistical Rating Organization, U.S. Securities and Exchange Commission, pp. 11-23 (Dec. 2020) (listing numerous deficiencies of certain NRSROs but not identifying their names and only indicating “smaller NRSRO” or “larger NRSRO”).
\item \textsuperscript{12} “Rule 436(g), promulgated by the Securities and Exchange Commission under the Securities Act of 1933, shall have no force or effect.”
\item \textsuperscript{13} 15 U.S.C. § 77k(a): “In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact . . . any person acquiring such security . . . may, either at law or in equity, . . . sue . . . every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having
Rule 436(g) deemed credit ratings to be not a part of the registration statement or prospectus, a special privilege not accorded to others such as accountants. As a result, NRSROs were not considered experts for the purpose of Section 11, thus shielding them from Section 11 liability. After the passage of the Dodd-Frank Act, rating agencies responded by threatening to withhold credit ratings or their consent to publish them. The SEC blinked. In response and in spite of the clear mandate in the Dodd-Frank Act § 939G, the SEC provided “no-action” letters permitting the exclusion of credit ratings from the registration statement and the prospectus. One surmises that the SEC may have acted in this way for fear of gumming up the deal flow pipeline in particular securities such as structured finance products if the rating agencies’ threat was carried out. These “no-action” letters are the subject of the proposed bill.

The SEC’s action flouts the Congressional intent in the Dodd-Frank Act, but its reasons may be grounded in a rational assessment of the market condition. The proposed bill would be legislative patch to the original concept in the Dodd-Frank Act, which would make the liability of rating agencies coterminous with other securities professionals such as accountants, auditors, and security analysts, including liability under Section 11. There are several groups of consideration at work.

First, one should consider the impact on the overall market if rating agencies in fact strike and withhold their consent. The questions are: (1) Would rating agencies in fact carry out the threat? (2) Would issuers engage rating agencies if they withhold their consent, or at least demand a discount off traditional fee structures on credit ratings without consent? (3) Would the demand of bond investors decline without credit ratings published in the registration statement or prospectus, thus gumming up the market? (4) If not, would steady investor demand marginalize the importance of credit ratings for certain credit products?

Since I am removed from the day-to-day market milieu, I am less qualified to opine on the above matters. It would be helpful to learn the responses from a representative sample of market professionals, including smaller rating agencies, investment bankers who must market bond issues, and an array of bond investors.

Second, one should consider the impact on competition among rating agencies. The questions are: (1) Would all nine NRSROs stand together in the strike, or would several cross the picket line? (2) Would some, particularly the smaller NRSROs, see the strike as a market opportunity and rush to fill the void? (3) Would the fee structures for credit ratings change due to a shrinkage of the supply of credit ratings?

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14 SEC No-Action Letter Issued to Ford Motor Credit Company LLC regarding Regulation AB Item 1120 (July 22, 2010); SEC No-Action Letter Issued to Ford Motor Credit Company LLC regarding Regulation AB Item 1120 (Nov. 23, 2010).
It may not be so easy to maintain a strike among a group of nine competitors. Smaller, more entrepreneurial NRSROs may indeed fill the void left by others. Financial industry actors are quick. Deals are rarely left on the table if the pricing is right. It is possible that a shrinkage of supply of credit ratings and a “litigation premium” could result in price increases. This may marginally increase the cost on issuers. But the benefit of such a possibility would be the continued growth of smaller NRSROs who have historically had trouble growing relative to the overall market.\footnote{See supra note 6.}

Third, one should consider the impact of Section 11 liability for money damages on the rating industry. The questions are: (1) Are rating agencies similarly situated with accountants and appraisers (who are specifically named in Section 11) with respect to liability exposure under Section 11 such that they deserve as a special carve out? (2) What would be the financial impact on rating agencies? (3) What would be the impact on the incentives of rating agencies?

Section 11 makes clear that all consenting experts are potential subject to liability and does not distinguish differences in the qualitative nature of their work. Accountants are subject to professional standards seen in accounting standards such as generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) and supported by a professional body. They have clearer and arguably more rigorous standards (though inter-professional comparisons are tricky), thus greater potential exposure if they deviate from these standards. Some of the qualitative and subjective judgments that go into credit analysis, such as forecasting, would make imposing liability on rating agencies more difficult, absent clear error, bad faith, or other malfeasance. There is no apparent need for distinguishing rating agencies from accountants with a special privilege.

The financial impact of added exposure to legal liability would of course be negative. In the past, rating agencies have paid substantial settlements.\footnote{The Credit Rating Controversy, Council on Foreign Relations (Feb. 19, 2015) (“In addition to its $1.37 billion settlement in February, S&P settled two other cases, paying $125 million to the nation’s largest pension fund, the California Public Employees’ Retirement System (Calpers), while settling with the SEC for $80 million in a post-crisis fraud case. While these sums combined are more than ten times larger than any other rating agency-related settlement, critics argue that they represent a mere slap on the wrist for S&P, which as part of the deal was not forced to admit to any criminal wrongdoing.”).} Section 11 liability would be different from liability based on other legal theories seen in the case law. Thus far, despite substantial settlements and regulatory fines, the overall success of legal actions against rating agencies seems to be mixed. Rating agencies have a plausible First Amendment defense that have been recognized in federal courts in varying degrees and with caveats of a complex area of constitutional law. Commentators have varying views on this defense. But it seems that litigation outcomes have thus far been a mixed bag, perhaps generally favoring rating agencies on the
whole. Section 11 would change the calculus of legal liability because the risk attaches with each registration statement under a clearly established statutory cause of action under the Securities Act of 1933.

Legal and economic theory states that an actor engages in a cost-benefit analysis to determine whether it should change behavior (take precautions) at each level of marginal increase in potential penalty. In other words, an actor thinks about the bottom line. A rating agency may be incentivized to take additional care against rating mishaps if the expected cost of liability outweighs the cost of precaution. I believe that, consistent with theory, exposure to Section 11 would result in the expenditure of greater care because liability could be high magnitude in light of high dollar values of the bond issuances. This would be a greater cost on the industry, but would produce greater care in the production of credit ratings.

The proposed bill is consistent with Dodd-Frank Act. It enforces the purpose of Section 939G, which legislatively overruled SEC Rule 436(g). It is also consistent with Dodd-Frank Act § 933, which achieves the right balance by making liability under federal securities law coterminous with that of auditors and security analysts.

(5) Accurate Climate Risk Information Act

This proposed bill requires NRSROs to “adopt, integrate, and publish a written policy on how the organization will consider climate-related risks in the credit ratings.” The language “will consider” is ambiguous. It could be construed as a mandate to include climate risk into the ratings model, or it requires only disclosure of how rating agencies treat climate change, if at all. A mandate to include climate risk into the models of rating agencies would encroach upon their substantive work. I say this not because climate risk is insubstantial or speculative. Science says otherwise, and climate change (global warming) affects credit risk on longterm instruments, though each firm applying its own model may differ on the magnitude of the influence on credit risk. But a mandate to include climate risk into credit models poses the question of whether Congress or the SEC has the substantive expertise or, even if they do, whether they should mandate a specific analysis of credit risk to private firms.

On the other hand, a disclosure approach is laudatory and compelling. Even to an informed layperson who believes in science, there can be little doubt that climate change affects credit risk. Consider a longterm 30-year bond issued by the following borrowers: a municipality situated on a coastline, a utility in the western states, a property and casualty insurer in the Gulf states, or a project finance for maritime infrastructure. ¹⁷ Climate risk does not necessarily represent a downside-biased in the

¹⁷ The U.S. military, an organization that depends on longterm strategic planning, is well aware of the threat of climate change and its affect on military preparedness. See David Vergun, *Action Team Leads DOD Efforts to Adapt to Climate Change Effects*, U.S. Department of Defense (Apr. 22, 2021), available at
probability of default. Among other things, the likelihood and magnitude of predicted fortuitous events, the issuer’s business and pricing model, and its risk management would affect the nature of the credit risk. Rating agencies should consider climate risk as a part of its credit modeling or explain to regulators and the public why they believe climate risk is trivial to credit risk. A disclosure requirement would make transparent how global warming affects credit ratings and the value of long-term debt instruments. This public information may influence the most efficient allocation of capital in an era of climate change, which would have broad consequences.

Concluding Comments

When rating agencies assess and publish credit ratings, they exert enormous power over the largest and important portion of the capital markets—the credit market. Their actions can have profound consequences on companies, investors, markets, nations, and peoples. The industry has a structural problem. They are few and not subject to market forces of good competition and incentives. The current industry configuration, in the main, is the same as it was before 2008.

The Dodd-Frank Act and earlier legislation incrementally reformed the industry. Some of these modest reforms mandate factfinding and contemplation by requiring reports. Numerous reports have been produced over the past decade. But these statutes have not changed the core problem of lack of competition, industry concentration, and structural bias. The reform of the credit rating industry is incomplete. It is my opinion that the five proposed bills contemplated by the House Subcommittee advance the goal toward more complete reform of the credit rating industry.

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https://www.defense.gov/Explore/News/Article/Article/2577354/action-team-leads-dod-efforts-to-adapt-to-climate-change-effects/. For example, naval bases could be adversely affected by rising seas, and global warming could destabilize some nations affecting the security interests of the United States in the homeland and abroad.

See A. Seetharaman et al., The Impact of Risk Management in Credit Rating Agencies, 5 Risk 52 (2017) (concluding that “market risk is internally correlated with credit risk, financial risk, and operational risk”).