

The Reciprocal Oversight Problem

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ABSTRACT: Sovereign ratings are designed to mitigate investors' risk exposure by highlighting the fiscal condition of governments. The problem is that sovereign ratings entail reciprocal oversight of rating agencies and sovereign governments—which raises conflicts of interest and, ironically, creates incentives for distorted risk assessments. Private rating agencies hold sovereign governments accountable by assessing their risk exposure, while sovereign governments hold rating agencies accountable through regulation. Both sovereign governments and rating agencies have incentives to leverage their mutual oversight to obscure risk taking and minimize accountability. During booms, governments and rating agencies have convergent interests in understating risks until market bubbles are on the cusp of bursting because bubbles produce higher tax revenue and profits. During busts, both sides blame one another for failing to accurately gauge risks, which fosters regulatory stalemates that perpetuate the absence of public and private accountability. Once the dust settles, the cycle of risk tolerance continues again with neither set of actors providing meaningful oversight of the other as both rating agencies and governments benefit from the renewed growth of the financial sector.

Overseeing rating agencies is difficult for sovereign governments because they face the temptation to abuse regulatory powers to neutralize rating agencies' ability to push back and expose the fiscal overstretch of governments. The simple alternative would be to utilize a self-regulatory organization approach to balance the need for regulation with rating-agency independence. But the stumbling block for self-regulation is that rating agencies are an oligopoly as three firms account for 96% of ratings, and self-regulation could reinforce the market power and entrenchment of the leading rating agencies. Instead, this Article advocates an intermediation strategy of integrating a broader array of ratings stakeholders into a stakeholder regulatory organization to oversee the industry. A range of stakeholders rely on the accuracy and integrity

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of ratings and would have an interest in ensuring that rating-agency regulation balances the need for greater procedural and substantive accountability with the need for rating-agency independence from the government. This approach would not deal with the other side of the coin—the fiscal overstretch of sovereign governments that have exposed them to increasing rating-agency scrutiny, which is a far more complex problem that is beyond the scope of this Article. But the logic is that integrating end users of ratings into deliberative processes will mitigate industry biases and produce rules that preempt the need for government regulation.

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I. INTRODUCTION

Both government regulation and self-regulation of rating agencies suffer from an inherent conflict of interest—the “reciprocal oversight problem.”¹ A dual principal-agent problem exists. Both sovereign governments and rating agencies oversee one another and have incentives to leverage their oversight roles to obscure risk taking and minimize responsibility for failure. The problem is that rating agencies and sovereign governments have a convergent interest in excessive risk taking during booms because each gains profits and tax revenue respectively from fueling excessive optimism. But when booms turn to busts, both sides blame one another and use their oversight roles to blunt accountability. The reliance of governments and rating agencies on the financial sector as an engine of growth means that once the bust subsides, there are strong incentives to return to the status quo of risk taking without effective public or private oversight. The result is a systematic failure of government and rating-agency accountability due to the perverse incentives created by mutual oversight.

The conventional understanding is that governments fail to exercise effective oversight of rating agencies because of private sector capture of regulators, or due to a failure to strike the right balance between government and self-regulation.² This Article argues that the roots of regulatory failure are

1. Most of the literature on the financial crisis (and earlier crises) has focused on the conflicts of interests facing financial industry self-regulation, but has overlooked the conflicts of interests of government actors and the impact of governments' fiscal overstretch in distorting the substance of regulation. See, e.g., William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 4–5 (2013) (discussing the creeping federalization of self-regulatory organizations in the wake of the financial crisis); Kimberly D. Krawiec, *The Return of the Rogue*, 51 ARIZ. L. REV. 127, 129–30 (2009) (critiquing “enforced self-regulation” by highlighting how banks abused the flexibility regulators gave them to assess operational risks and capital requirements); Jonathan R. Macey & Maureen O’Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 STAN. L. REV. 563, 565–68 (2005) (analyzing the conflict of interest between securities participants’ interests in effective self-regulation and their profit-driven focus).

2. For example, “new governance” scholars have frequently famed the choice between self-regulation and government regulation as a spectrum choice that entails ongoing negotiations and give and take over policies and enforcement. See, e.g., Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 BROOK. J. CORP. FIN. & COM. L. 317, 323–24 (2007) (discussing the enduring appeal of self-regulation to securities and financial regulators as a strategy for outsourcing regulatory burdens and costs to the private sector); Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L.J. 1, 29–36 (2008) (applying the assumptions underpinning “new governance” scholarship to securities regulation and arguing that the dynamic interaction between government regulators and self-regulatory organizations gives both sides “incentives to be trustworthy and open with the other”); Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 548–50 (2000) (framing the interface of government and self-regulation “as a set of negotiated relationships” between the public and private sector); Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 153–55 (2008) (calling for self-regulatory organizations to be treated as government actors because of the degree to which the government delegates regulatory roles); Orly Lobel, *The Renew Deal: The Fall of Regulation and the*

far deeper and stem from two interconnected problems. Governments throughout much of the developed world have engaged in “fiscal overstretch.” Governments that cannot meet spiraling present and future spending and entitlement commitments with tax revenue have exposed themselves to the oversight of and accountability to the financial sector because of their need for increasing levels of debt and tax revenue. Clashes over sovereign rating downgrades capture the weakened fiscal state of governments and also expose the ability of the financial sector to exploit this weakness to push back against government oversight and regulation.

This problem has helped to reinforce the financialization of the economy. The increasing size of the financial sector and centrality to the economy has led governments to over-rely on the financial sector in booms and busts and blunted effective oversight and accountability of both financial actors and financial gatekeepers, such as rating agencies and accounting firms. Governments face an imperative of pursuing higher economic growth for fiscal stability—which has led to tolerance of greater risk taking and greater vulnerability when financially-driven booms turn to busts.

Relaxing the reins over the financial sector is a classic problem that arises due to excessive optimism about the durability of economic booms and the machinations of the financial industry lobby. But what has changed over the last generation is the degree of vulnerability of the state and the degree of oversight of the state by the private sector. The twist of rating-agency oversight of government is that rating agencies have leveraged their oversight roles to make both their silence and words about the government’s fiscal condition pay regulatory dividends.

The reciprocal oversight problem is pervasive throughout the financial world. For example, regulatory incentives for banks to hold sovereign debt to satisfy their capital requirements have created a vicious cycle of mutual dependency.³ Incentivizing national banks to purchase sovereign debt meant that each developed country has expanded its debt capacity by deepening interconnections with its banking system. When the banks took reckless risks that caused the financial crisis, the resulting liquidity crunch led to

Rise of Governance in Contemporary Legal Thought, 89 MINN. L. REV. 342, 360–68 (2004) (providing an overview of the “new governance” paradigm which rejects equating deregulation with devolution and instead posits that self-regulation entails ongoing constructive roles for government regulators and law); Saule T. Omarova, *Wall Street as Community of Fate, Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 421–30 (2011) (providing an overview of the “new governance” literature on the complementary regulatory roles of government regulators and self-regulatory organizations); Darren Sinclair, *Self-Regulation Versus Command and Control?: Beyond False Dichotomies*, 19 LAW & POL’Y 529, 531 (1997) (discussing how academics and policymakers often falsely present a choice between the extremes of government control and complete self-regulation).

3. See Danièle Nouy, *Is Sovereign Risk Properly Addressed by Financial Regulation?*, 16 FIN. STABILITY REV. 95, 96–97 (2012) (discussing the concern that Basel III risk-weighting of bank capital gives banks a strong incentive to invest in sovereign debt and understate the risks).

government guarantees, assumptions of private debt, and fiscal stimulus. These sweeping commitments in turn were financed by government debt purchased by many of the national banks at the root of the problem. A similar paradox of mutual oversight occurs in the mortgage industry as significant government roles in mortgage securitizations, the reliance on housing as a spur for economic growth, and government tax incentives for mortgages have deepened government interconnections with and oversight by the private sector.⁴

The clash between rating agencies and governments provides a stark illustration of how the reciprocal oversight problem may compromise the efficacy of government and self-regulation. Countries can potentially use regulatory powers to incentivize rating agencies to heighten accuracy and timeliness or to pressure rating agencies to cast a blind eye to the government's fiscal overstretch.⁵ Rating agencies can use threats of sovereign downgrades to tacitly push back against regulations and leverage the fact that their assessments of sovereigns' creditworthiness affect the state's ability to finance national debts and the broader economy.⁶ This conflict of interest distorts the incentives of both sovereigns and rating agencies and has

4. See Douglas J. Elliott, *The Federal Role in Housing Finance*, in *THE FUTURE OF HOUSING FINANCE: RESTRUCTURING THE U.S. RESIDENTIAL MORTGAGE MARKET* 2, 2–8 (Martin Neil Bailly ed., 2011) (providing an overview of the U.S. federal government's role in housing finance).

5. Compare Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act, Pub. L. No. 111–203, §§ 939D–F, 124 Stat. 1376, 1888–90 (2010) (codified as amended at 15 U.S.C. § 780–9) (mandating that the SEC develop an alternative for the current conflicts of interest created by debt issuers selecting and paying their rating-agency gatekeepers), with Bradley Hope & Damian Paletta, *S&P Chief Says Geithner Warned About U.S. Downgrade*, WALL ST. J. (Jan. 21, 2014, 4:51 PM), <http://www.wsj.com/articles/SB10001424052702304757004579334681896829464> (discussing how then Treasury Secretary Timothy Geithner allegedly threatened S&P's chairman with retaliation if S&P downgraded the federal government), and Alejandro Lazo & Andrew Tangel, *Justice Department Sues S&P Over Mortgage Bond Ratings*, L.A. TIMES (Feb. 4, 2013), <http://articles.latimes.com/2013/feb/04/business/la-fi-sandp-justice-20130205/2> (discussing how S&P was singled out as the target of a landmark Department of Justice lawsuit for subprime mortgage related fraud even though the same action could have plausibly been brought against any of the three leading rating agencies).

6. Compare Standard & Poor's, *Sovereign Government Rating Methodology and Assumptions*, June 24, 2013, at 3–34 [hereinafter *S&P Sovereign Rating*], available at http://www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldata&blobtable=MungoBlobs&blobheadervalue2=inline%3B+filename%3DSovereign_GovernmentRatingMethodology_Assumptions_7_9_13.pdf&blobheadername2=Content-Disposition&blobheadervalue1=application%2Fpdf&blobkey=id&blobheadername1=content-type&blobwhere=1244295767050&blobheadervalue3=UTF-8 (laying out the quantitative and qualitative dimensions of Standard & Poor's methodology for assessing the creditworthiness of sovereigns), with Jeffrey Manns, Op-Ed., *The Revenge of the Rating Agencies*, N.Y. TIMES (Aug. 9, 2011), <http://www.nytimes.com/2011/08/10/opinion/the-revenge-of-the-rating-agencies.html> (raising the concern that S&P's historic downgrade of the federal government's credit rating—and other rating agencies' threats to act likewise—were motivated by the desire to deter meaningful rating-agency reform).

undercut rating-agency reform in both the United States and European Union.⁷

This Article argues that regulators could partly mitigate the impact of the reciprocal oversight problem on rating-agency regulation by creating *stakeholder regulatory organizations*. The distinguishing feature of a stakeholder regulatory organization from conventional self-regulatory organizations is that it would include a spectrum of stakeholders in decision-making on industry rules, rather than solely empower industry actors to police themselves.⁸ The logic is that integrating both the demand and supply side of financial services into deliberative processes will mitigate industry biases and produce rules that preempt the need for government regulation. Economic booms often dampen incentives for both governments and stakeholders to address regulatory problems. But economic busts create popular pressure for government action, and the threat of government regulation or regulatory defaults would spur stakeholders to forge consensus on regulatory reforms.⁹ This approach does not address the consequences of fiscal overstretch by governments which is a far larger problem that is beyond the scope of this work. But it would offer a plausible path forward for a middle way that tempers the potential excesses of government and self-regulation of rating agencies.

7. See, e.g., John C. Coffee, Jr., *Ratings Reform: The Good, the Bad, and the Ugly*, 1 HARV. BUS. L. REV. 231, 233–36 (2011) [hereinafter Coffee, *Ratings Reform*] (providing an overview of the merits and shortcomings of legislators' vision for rating-agency reforms); John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends To Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1050 (2012) (discussing how inconsistent or poorly designed reforms are inevitable because Congress engages in rapid-fire reforms due to pressure from time and interest groups); Jeffrey Manns, *Downgrading Rating Agency Reform*, 81 GEO. WASH. L. REV. 749, 754–58 (2013) (discussing how pushback from rating agencies coupled with regulatory indecision had led each of the most significant aspects of American rating-agency reform to be abandoned or watered down).

8. Integrating a range of stakeholders into self-regulatory organizations offers a novel, market-oriented way to address the biases of both government and self-regulated actors. The goal is to provide internal accountability within the self-regulatory organization *ex ante*, rather than more amorphous external accountability and oversight *ex post*. While a number of post-financial-crisis proposals have sought to change *ex ante* incentives, none has explored the potential for bringing stakeholders within self-regulatory organizations. Cf. Viral V. Acharya, *A Theory of Systemic Risk and Design of Prudential Bank Regulation*, 5 J. FIN. STABILITY 224, 230–35 (2009) (arguing government-imposed capital structure reforms are the key to mitigating systemic risk and improving the financial sector's resiliency); Omarova, *supra* note 2, at 413–14 (arguing that holding banks as a whole financially accountable for other banks' failures would heighten mutual policing and restraint); Lasse Pedersen & Nouriel Roubini, *A Proposal to Prevent Wholesale Financial Failure*, FIN. TIMES (Jan. 29, 2009), <http://www.ft.com/cms/s/0/4doadd58-ee27-11dd-b791-0000779fd2ac.html> (calling for mandatory insurance on all financially related institutions to create risk pooling and limit systemic risk exposure).

9. The “regulatory default” concept has been used in the environmental-law context to provide regulated parties with incentives to produce new information and make the case for alternatives. See, e.g., Bradley C. Karkkainen, *Information-Forcing Environmental Regulation*, 33 FLA. ST. U. L. REV. 861, 869–70 (2006).

II. THE RECIPROCAL OVERSIGHT PROBLEM

A. *THE INHERENT CONFLICTS OF INTEREST FROM MUTUAL OVERSIGHT*

Policymakers and academics have been consumed in post-financial crisis debates about the virtues and vices of government regulation versus industry self-regulation. But they have systematically overlooked the “reciprocal oversight problem”—the conflicts of interest that mutual oversight of the federal government and the financial industry create.¹⁰ The crux of the problem is that both the government and private actors oversee one another and have incentives to use and abuse their powers to obscure their risk taking or overstretch. The financial crisis starkly exposed the reciprocal oversight problem and its impact in compromising the efficacy of both government and self-regulation.

In theory, mutual oversight could be a virtue and mitigate the perpetual policy challenge of “who watches the watchmen.”¹¹ Unsupervised governments may run amuck, both in terms of fiscal expenditures and abuses of power, just as easily as the financial industry may exploit pure self-regulation to legitimize reckless risk taking and craft pro-industry rules at the public’s expense.¹² Reciprocal oversight may temper abuses to the extent that government and industry use their monitoring roles to further the public interest of private and public accountability. That outcome is most likely in spheres where the government, industry, and public interest overlap, such as embracing greater transparency. This strategy has been the favored tactic of both securities regulation and government accountability over the past generation because it entails minimal expenditures, imposes no new substantive restrictions, and in theory furthers both public accountability and market discipline.¹³

10. See, e.g., Birdthistle & Henderson, *supra* note 1, at 4–5; Krawiec, *supra* note 1, at 129–30; Macey & O’Hara, *supra* note 1, at 565–68.

11. This interface of public and private oversight raises one of the basic challenges of public governance. As Plato framed the issue in *The Republic*, “*quis custodiet ipsos custodes?*” Translated, this means: who will watch the watchmen? See JUVENAL, *Satires VI*, in *THE SATYRS OF DECIMUS JUNIUS JUVENALS* 62, 79 (Dryden et al. trans., 1979) (1735) (“[W]ho [s]hall keep tho[s]e Keepers?”). This tension is particularly sharp when both the private and public sector have roles in overseeing one another.

12. See, e.g., Paul R. Verkuil, *Public Law Limitations on Privatization of Government Functions*, 84 N.C. L. REV. 397, 399–400 (2006) (discussing the potential privatization paradox which enables the government and private sector to benefit from outsourcing government roles, while simultaneously reducing the effectiveness of both public and private scrutiny of privatized functions).

13. See, e.g., Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 649–51 (2011) (discussing how the subprime-mortgage market exposed the limits of transparency as a tool to protect investors); Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1043 (2009) (discussing securities regulation’s reflexive use of transparency and disclosure requirements to protect investors, regardless of its efficacy); Susanna Kim Ripken, *The Dangers and Drawbacks of the*

The dilemma is that government and financial industry interests may systematically diverge from the public interest because neither benefits from facing the shackles of external accountability.¹⁴ This problem is the starkest in the context of rating agencies. Both governments and rating agencies have incentives to leverage their respective monitoring roles to undercut accountability or reforms that target their conduct. During economic booms the interests of governments and rating agencies diverge with the public interest of mitigating the danger of market bubbles and imbalances. But governments' and rating agencies' interests converge with one another to understate risk for mutual benefit. That is what happened in the run up to the financial crisis. Governments and rating agencies downplayed or ignored risks because the benefits of higher rates of return for investors, greater economic growth, and higher tax revenue were immediate, while the likelihood that risk taking would have negative consequences appeared remote.¹⁵

But when booms turn to busts, government and rating-agency interests diverge because each wishes to deflect blame and avoid the consequences of reckless risk-taking.¹⁶ The economic fallout exposes the depth and

Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation, 58 BAYLOR L. REV. 139, 185–90 (2006) (discussing the limits of the pre- and post-Sarbanes–Oxley disclosure systems for securities regulation); Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in Insurance Consumer Protection*, 61 UCLA L. REV. 394, 409–13 (2014) (discussing the merits of transparency as a tool of accountability in the securities and insurance context); David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152, 193 (2012) (discussing the virtues of greater standardization and transparency from exchange trading of over-the-counter derivatives).

14. The term “public interest” is by definition contestable and frequently manipulated by both public and private actors to advance their agenda. I employ the concept of public interest narrowly as a proxy for the desirability of both public and private accountability. See, e.g., Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 94–96 (1998) (discussing how public-interest groups seek to represent the diffuse interests of citizens writ large against more powerful special interests); Scott L. Cummings, *The Pursuit of Legal Rights—and Beyond*, 59 UCLA L. REV. 506, 517–18 (2012) (discussing the multiple definitions used to capture the idea of public interest); Mark Green & Ralph Nader, *Economic Regulation vs. Competition: Uncle Sam the Monopoly Man*, 82 YALE L.J. 871, 876 & n.31 (1973) (discussing how government regulators routinely prioritize narrow, industry interests over the public good).

15. See, e.g., DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD–FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* 39–40 (2011) (providing examples of regulatory mistakes that led to the financial crisis); Jeffrey Manns, *Insuring Against a Derivative Disaster: The Case for Decentralized Risk Management*, 98 IOWA L. REV. 1575, 1582–84 (2013) (discussing how a broad range of public and private actors lacked incentives to curb risk taking in the run up to the financial crisis until it was too late).

16. See, e.g., Vikas Bajaj, *If Everyone's Finger-Pointing, Who's to Blame?*, N.Y. TIMES (Jan. 22, 2008), <http://www.nytimes.com/2008/01/22/business/22legal.html> (discussing the myriad of suits and countersuits filed among the parties involved in the subprime mortgage crisis); Michel G. Crouhy et al., *The Subprime Credit Crisis of 2007*, J. DERIVATIVES, Fall 2008, at 81, 95–97 available at https://www.fdic.gov/bank/analytical/cfr/bank_research_conference/annual_8th/Turnbull_Jarrow.pdf (discussing the array of public and private actors who share culpability for the subprime mortgage crisis).

significance of the reciprocal oversight problem as the federal governments and rating agencies have incentives to use the leverage they have over one another to undercut public and private accountability. Both will give lip service to the public interest in advocating for or against financial reforms. But the end result of this conflict is frequently a convergence on watered-down reforms that reflect the power that the public and private sector have over one another and their mutual absence of accountability.¹⁷ Once the crisis is behind them and memories fade, then governments, rating agencies, and other financial actors converge on the status quo of acquiescing to, if not embracing, increasing levels of risk taking.

The reciprocal oversight problem is partly one of the governments' own making and partly a reflection of the shortcomings of self-regulation of both rating agencies and the financial industry more broadly. Years of fiscal overstretch from massive budget deficits have exposed governments to the scrutiny of the financial world because of the need to raise ever-increasing amounts of debt.¹⁸ At the same time, decades of deference to industry self-regulation and reliance on the financial sector as a source of strength for economic growth meant that regulators had incentives for hands-off policies as risks mounted during the housing market bubble.¹⁹ Once the crisis struck, governments faced public pressure for accountability for rating agencies and the broader financial sector. But reforms were limited by the reality that the financial sector had significant leverage to affect governments' solvency as well as the health of the fragile economy.²⁰

The growing financialization of the economy is a regulatory challenge in its own right that has reinforced the impact of governments' fiscal overstretch. For example, since World War II, the GDP share of the United States financial sector has roughly tripled.²¹ The growth rate of the financial sector accelerated from the advent of deregulation in the late 1970s with the financial sector's accounting for 45% of U.S. corporate profits at the peak of

17. See *infra* Parts III.C–D.

18. See Steven L. Schooner, *Fear of Oversight: The Fundamental Failure of Businesslike Government*, 50 AM. U. L. REV. 627, 628–30 (2001) (discussing how the outsourcing of government functions has heightened the need for private monitoring of government activity); Steven L. Schwarcz, *Rollover Risk: Ideating a U.S. Debt Default*, 55 B.C. L. REV. 1, 3–9 (2014) (discussing how increasing levels of U.S. debt are leading to heightened scrutiny of the federal government's borrowing capacity).

19. See Brooksley Born, *Deregulation: A Major Cause of the Financial Crisis*, 5 HARV. L. & POL'Y REV. 231, 232–33 (2011) (discussing how federal regulators' review of their conduct revealed the degree to which excessive deference and false assumptions fueled the crisis).

20. See, e.g., Viral V. Acharya, *Governments as Shadow Banks: The Looming Threat to Financial Stability*, 90 TEX. L. REV. 1745, 1745–47 (2012) (discussing how governments encourage the growth of the financial sector at the cost of future instability as the size and the significance of the financial sector to the economy limits the ability to reform it).

21. See Thomas Philippon, *Why Has the U.S. Financial Sector Grown So Much?: The Role of Corporate Finance* 2–3 (Nat'l Bureau of Econ. Research, Working Paper No. 13405, 2007), available at <http://www.nber.org/papers/w13405.pdf>.

the bubble in 2007.²² While the financial crisis took away some of the luster and profitability from the banking world, the financial sector of the economy has grown at a markedly higher pace than the rest of the economy, which has altered the balance between the government and the financial sector.²³

The growth of the financial sector has given financial actors leverage against the government to push for lax regulation during booms, to extract bailouts during busts, and to minimize accountability during economic recoveries. Governments reliant on higher economic growth to grow their way out of fiscal problems face difficulties in regulating the financial entities who are needed to spur the economy. The growing size of the financial sector has also empowered financial intermediaries, such as rating agencies, to use their role in assessing market risk as a cudgel to similarly push back against state oversight.

The ultimate irony of the government's fiscal overstretch and the financialization of the economy is that it creates incentives for federal government leaders to have a half-hearted commitment to creating oversight of the financial system and rating-agency accountability. The fear is that a system that accurately reflects risks would expose the scope of government's own financial problems and imbalances in the economy.²⁴ In that sense, there is a lasting convergence of interest between the government, rating agencies, and the broader financial sector to downplay risks during economic expansion and limit accountability (towards themselves) in the wake of economic fallout.

The government's exposure to market oversight is potentially a virtue in that the political process is failing to lead to government fiscal restraint, and market pressure may be the only way to reel in the free-spending ways of short-sighted politicians. The danger is that this role has given rating agencies and other financial actors significant leverage to push for autonomy from government oversight during booms and to push back at government regulations in the wake of crises.

22. See GRETA R. KRIPPNER, CAPITALIZING ON CRISIS: THE POLITICAL ORIGINS OF THE RISE OF FINANCE 5–10 (2011) (noting that the finance-sector's share of U.S. corporate profits tripled from about 15% of profits in 1980 to a peak of 45% of corporate profits in 2007); see also Ken-Hou Lin & Donald Tomaskovic-Devey, *Financialization and U.S. Income Inequality, 1970–2008*, 118 AM. J. SOC. 1284, 1285 (2013) (noting financialization's impact on non-finance-sector firms and observing that the ratio of financial income (rather than business income) to realized profits for non-finance-sector firms increased from 0.15 to 0.32 from 1970 to 2008).

23. See, e.g., Samuel Antill, David Hou & Asani Sarkar, *Components of U.S. Financial-Sector Growth, 1950–2013*, 20 ECON. POL'Y REV. 59 (2014); Gerald A. Epstein & Arjun Jayadev, *The Rise of Rentier Incomes in OECD Countries: Financialization, Central Bank Policy and Labor Solidarity*, in FINANCIALIZATION AND THE WORLD ECONOMY (G. Epstein ed., 2005).

24. Acharya, *supra* note 20, at 1746–47 (discussing governments' short-term time horizon which makes leaders wish to avoid full disclosure of the long-term state of the financial sector and the government's own finances).

B. THE LIMITS OF SELF-REGULATION

The federal government merits blame for having conflicts of interest in its regulatory roles, but the perverse incentives financial actors have to leverage their economic impact and government oversight role makes self-regulation problematic. Traditionally, self-regulation and market discipline turned on the power of reputational checks and self-interest as constraints.²⁵ The underlying assumption was that financial actors would not endanger their fiscal health and reputation by embracing strategies that enabled short-term risk-taking at the expense of their long-term interests.²⁶ Rating agencies and other financial intermediaries, such as lawyers and accountants, were believed to have the strongest incentives for “self-interested restraint” since their reputations for integrity are key to their opinions having value.

But this assumption that self-regulation would constraint bubbles proved to be incorrect in the run up to the financial crisis. Reputational constraints waned amidst bubble markets and increases in risk-taking activities by market participants. Self-interest proved to be an inadequate restraint as financial actors succumbed to herding effects in converging on increasingly high-risk strategies for fear of being left behind.²⁷ For example, the conventional wisdom for investing in collateralized debt obligations, such as subprime-mortgage-backed securities, was the assumption that the market as a whole could not be wrong. Even though these instruments were opaque, investors erroneously assumed that prices reflected informational efficiency and that the relationship between risk and return was justified.²⁸ Rating agencies got caught up in the euphoria, too, as ratings reflected market expectations of securities, rather than their fundamental value.

For this reason, reliance on self-regulation and market discipline alone appear to be an inadequate restraint against excessive risk taking. If governments face conflicts of interest in regulating financial risk, and if

25. This reputational capital argument is frequently used to justify self-regulation. See, e.g., Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 786–98 (2001) (arguing that reputational constraints work in contexts in which institutions are repeat players and will suffer a reputational loss from fraud or deception that exceeds any short-term economic gains from the deception); Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL STUD. 295, 296–98 (1988) (arguing that the reputational costs that accountants may face from failing to detect wrongdoing provide them with adequate incentives to monitor their clients).

26. See John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1406 (2002) (discussing the virtues of reputational constraints in incentivizing securities gatekeepers).

27. See Mehrsa Baradaran, *Reconsidering the Separation of Banking and Commerce*, 80 GEO. WASH. L. REV. 385, 411 (2012) (discussing the role of herding effects in fueling the financial crisis).

28. See, e.g., Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2041 (2007) (embracing the subsequently discredited market sentiment that market incentives and legal structures allowed investors to invest “safely” in top-rated subprime mortgage securities).

individual financial actors may fail to self-regulate effectively during market bubbles, the question remains of whether another regulatory strategy may have a higher potential to mitigate risk exposure. One potential strategy to consider is the merits of addressing financial industry regulation at a collective level through self-regulatory organizations. Self-regulatory organizations were created for a range of securities-related actors in the United States as a way to remedy the limits of government regulators.²⁹ The logic is simple that market participants as a whole are often better positioned to recognize and address emerging problems than regulators and have incentives to do so to avoid heavy-handed or misguided regulation.³⁰ Delegating a degree of self-regulation responsibilities to industry participants seeks to leverage self-interest in a constructive way through encouraging cooperation and collective action.³¹ Self-regulatory organizations are designed to potentially craft solutions to preempt both potential disaster and the threat of government regulations in a more time- and cost-effective way. Industry participants would have incentives to design rules that can be practically implemented and to monitor one another for compliance in order to preempt government regulators stepping in.³²

Reliance on self-regulation entails accepting as a necessary evil a degree of conflicts of interest from parties regulating themselves.³³ For example, industry participants may exploit the degree of deference to self-regulation to push for lax regulation and oversight. The challenge is that financial actors may be better positioned to identify and address emerging problems than regulators, but financial actors are also better positioned to downplay or

29. See Birdthistle & Henderson, *supra* note 1, at 8–11 (discussing the rationale for self-regulatory organizations); Karmel, *supra* note 2, at 152–54 (providing an overview of securities self-regulatory organizations); Omarova, *supra* note 2, at 421–29 (providing an overview of the academic literature on the role of self-regulatory organizations as a governance tool).

30. See Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1463–67 (1993) (discussing the limitations of government regulators' ability to oversee complex financial risks).

31. See Douglas C. Michael, *Federal Agency Use of Audited Self-Regulation as a Regulatory Technique*, 47 ADMIN. L. REV. 171, 181–84 (1995) (providing an overview of self-regulation's virtues, such as industry insiders' advantages in recognizing and swiftly and cost-effectively addressing industry ills).

32. See WOLFGANG SCHULZ & THORSTEN HELD, *REGULATED SELF-REGULATION AS A FORM OF MODERN GOVERNMENT: AN ANALYSIS OF CASE STUDIES FROM MEDIA AND TELECOMMUNICATIONS LAW* 61–62 (2004) (discussing how self-regulation can facilitate more rapid decision-making and implementation than government rulemaking); Christodoulos Stefanadis, *Self-Regulation, Innovation, and the Financial Industry*, 23 J. REG. ECON. 5, 6–8 (2003) (discussing how self-regulation facilitates the rapid development of industry-wide innovation and standards).

33. See Edward J. Balleisen, *The Prospects for Effective Coregulation in the United States: A Historian's View From the Early Twenty-First Century*, in *GOVERNMENT AND MARKETS: TOWARD A NEW THEORY OF REGULATION* 443, 463–65 (Edward J. Balleisen & David A. Moss eds., 2010) (discussing how self-regulation entails inherent tradeoffs, yet may be the only practical way to address cross-border challenges).

obscure those risks due to overly optimistic assumptions or faith in markets.³⁴ With 20/20-hindsight financial actors may face government scrutiny, but by then the next set of economic or regulatory issues may be on the horizon and industry participants may never face meaningful accountability for their failures.³⁵

In the run up to the financial crisis, self-regulatory organizations enabled, rather than limited risk taking, by embracing rules that relied primarily on market participants' interests rather than on safeguards and accountability. Derivatives regulation epitomized this approach in the run up to the financial crisis. The International Swaps and Derivatives Association standardized derivatives contracts, but trusted in participants' self-interest to constrain risk taking rather than employing transparency, margin, or clearinghouse requirements.³⁶

The structural shortcoming of self-regulatory organizations is that they represent the interests of their industry, regardless of how much they give lip service to broader interests. While the boards of directors of self-regulatory organizations may include outsiders, the decision-makers within the organizations consist almost exclusively of financial industry members.³⁷ For example, the board of directors of the Financial Industry Regulatory Authority ("FINRA") includes ostensibly independent directors with connections to the financial industry.³⁸ But the actors who define the rules

34. See Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1025–26 (2009) (discussing how private actors' informational advantage over regulators can be a two-edged sword allowing them to anticipate and obscure potential problems).

35. See Sinclair, *supra* note 2, at 535–38 (discussing the limits of self-regulation and how self-regulated parties may exploit these shortcomings to thwart regulation and oversight).

36. See, e.g., Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763A-365 (codified as amended in scattered sections of 7, 11, 12, 15 U.S.C) (excluding a broad range of derivatives transactions from the SEC's and Commodity Futures Trading Commission's ("CFTC") jurisdiction, leaving them subject only to industry self-regulation); Willa E. Gibson, *Investors, Look Before You Leap: The Suitability Doctrine Is Not Suitable for OTC Derivatives Dealers*, 29 LOY. U. CHI. L.J. 527, 531 (1998) (arguing that over-the-counter derivatives transactions should be viewed as arms-length transactions which do not require more invasive regulation); Kimberly D. Krawiec, *More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1, 4–5 (1997) (arguing that since derivatives markets are a zero-sum game, regulation is appropriate only with respect to risks that threaten the financial system as a whole); Jonathan R. Macey, *Derivative Instruments: Lessons for the Regulatory State*, 21 J. CORP. L. 69, 82–89 (1995) (arguing that the economic function of largely unregulated derivatives is no different than other traditional financial instruments and that derivatives should not be regulated). *But see* Brooksley Born, *International Regulatory Responses to Derivatives Crises: The Role of the U.S. Commodity Futures Trading Commission*, 21 NW. J. INT'L L. & BUS. 607, 607–08 (2001) (discussing the CFTC's cooperation with foreign regulators to resolve derivatives crises and arguing for greater international cooperation and harmonization in the future to oversee the derivatives industry).

37. See Macey & O'Hara, *supra* note 1, at 570–71 (discussing how the profit focus of members of self-regulatory organizations shapes these organizations' agendas).

38. See *FINRA Board of Governors*, FIN. INDUSTRY REG. AUTHORITY, <https://www.finra.org/AboutFINRA/Leadership/Poog756> (last visited Mar. 23, 2015).

regulating broker-dealers at FINRA consist primarily of industry participants. Industry participants may understand the challenges of this sphere of the securities industry better than anyone else, but they also collectively have the self-interest to design rules that entrench their industry and favor their interests over investors.

The primary check against self-regulatory organizations enacting rules exclusively favorable to their industry is the fear of a government reaction of more stringent regulations, enforcement, or a reputational backlash. The danger is that reputational constraints will wane during economic booms as markets will discount risks because of over-confidence and give self-regulatory organizations space to fuel, rather than curb, risk taking. While the government is tasked with taking the punch bowl away from the party during economic expansions, regulators may be equally prone to false assumptions that systematically underestimate market risks and defer to self-regulatory organizations.³⁹

C. THE CASE FOR A STAKEHOLDER REGULATORY ORGANIZATION

One of the basic challenges facing self-regulatory organizations is the issue of whom these self-regulatory bodies are (or ought to be) accountable to.⁴⁰ Government recognition of self-regulatory organizations equips these organizations with legitimacy, as well as vests them with the power to set the rules of the game of industry conduct and to police one another's conduct. The dilemma is that these responsibilities may come without the government providing meaningful oversight or accountability.⁴¹ The reciprocal oversight problem may lead the government to defer to self-regulatory organizations to do whatever it takes to keep the financial sector vibrant in the short run, even if it fosters long-run problems. The danger of pushback from industry may compromise any efforts to hold self-regulatory organizations accountable for their role in failing to police themselves appropriately. The net result is that self-regulatory organizations may serve as thinly veiled tools of entrenchment and collusion.⁴²

The shortcoming of the self-regulatory organization model is that end users and other stakeholders have no say in industry rules or enforcement. One answer to this problem is to create greater accountability to end users through litigation exposure. For example, strengthening private causes of

39. See, e.g., Born, *supra* note 19, at 235–38 (discussing excessive deference by federal regulators).

40. See Birdthistle & Henderson, *supra* note 1, at 39–41 (discussing the inherent “diffusion of accountability” in the self-regulatory organization approach).

41. See, e.g., Karmel, *supra* note 2, at 186–88 (arguing that self-regulatory organizations should be treated as government actors to heighten accountability).

42. See, e.g., Onnig H. Dombalagian, *Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System*, 39 U. RICH. L. REV. 1069, 1093 (2005) (discussing the risk of self-regulatory organizations serving as vehicles for collusion).

action for end users for fraud or negligence would give end users greater incentives for monitoring and dampen incentives for self-regulatory organizations to defer to their members. The problem is that litigation is a blunt tool. Both legislatures and courts would have difficulty balancing the degree of liability exposure for securities actors with heightened incentives for more effective self-regulation.⁴³

Rather than replacing one market distortion with another, it would be desirable to foster *ex ante* accountability to the spectrum of stakeholders who rely on financial and securities actors. Creating a *stakeholder regulatory organization* would recognize the desirability of collective action and seek to temper the biases of the current system by giving stakeholders a say in overseeing the securities industry and developing industry standards.⁴⁴ The idea of a stakeholder regulatory organization is appealing because it could potentially address some of the shortcomings of both government and self-regulation by bringing stakeholders together to work on building consensus about regulations. The marketplace experience of stakeholders would make them better informed than government actors about the strengths and weaknesses of the financial world and better positioned to develop and critique industry standards.⁴⁵ But the stakeholder regulatory organization would go a step further in bringing together representatives of the range of actors whose economic fortunes are directly affected by securities actors. The divergent interests of a range of stakeholders would mitigate some of the

43. See, e.g., Randall S. Thomas & Robert B. Thompson, *A Theory of Representative Shareholder Suits and Its Application to Multijurisdictional Litigation*, 106 NW. U. L. REV. 1753, 1756–58 (2012) (discussing the challenges judges and government regulators face in balancing limits on liability exposure with ensuring deterrence in the securities context).

44. The academic debate on self-regulatory organizations has focused on the degree of government control versus the degree of industry control. See, e.g., Julia Black, *Decentering Regulation: Understanding the Role of Regulation and Self-Regulation in a 'Post-Regulatory' World*, 54 CURRENT LEGAL PROBS. 103, 115–18 (2002) (discussing the spectrum of degrees of government and industry self-regulation); Neil Gunningham & Joseph Rees, *Industry Self-Regulation: An Institutional Perspective*, 19 LAW & POL'Y 363, 391–92 (1997) (discussing the continuum of industry self-regulation from voluntary self-regulation to mandated partial self-regulation and full government control); Omarova, *supra* note 2, at 438–39 (advocating embedded self-regulation consisting of an integration of government regulation and self-regulation). But no one has raised the idea of a *stakeholder regulatory organization* that incorporates the spectrum of stakeholders into industry regulation. This approach is designed to mitigate the shortcomings of the targeted industry's ability to regulate itself and to move out of the shadows the behind-the-scenes lobbying by stakeholders that takes place with government regulation.

45. While securities self-regulatory organizations frequently have an adjudicative role to resolve claims against its members, the focus of this Article is on the potential role a stakeholder regulatory organization could play in developing industry standards and engaging in rule-making. The conflicting interests of a spectrum of stakeholders may make it more difficult for the organization to adjudicate claims between different factions of the stakeholder regulatory organization's membership. See Birdthistle & Henderson, *supra* note 1, at 62–64 (discussing the adjudicative role of U.S. self-regulatory organization FINRA).

concerns about self-regulation by making it less likely that rules would be skewed in favor of a particular industry group.

The key questions to address are how to select representatives for the range of stakeholders and how to incentivize a spectrum of financial actors with divergent interests to forge consensus. Bringing in a range of stakeholders to grapple with regulatory issues has intrinsic appeal. That in theory is the core logic of administrative agency notice and comment periods which give the general public, including affected industry groups, the chance to offer their perspective on proposed rules and regulations.⁴⁶ A stakeholder regulatory organization would go a step further in giving a range of stakeholders a more concrete role in forging regulations.

If a government agency or independent commission were tasked with creating a stakeholder regulatory organization, one of the biggest questions they would have to address is how to determine which stakeholders should get a seat at the table in decision-making to ensure a spectrum of interests are represented. The shortcomings of requirements for independent directors highlights the danger of trusting a government or independent commission to select stakeholder representatives without a clear selection criteria as they may have incentives to tilt the system towards their interests. Regulatory requirements call for public companies to have a majority of directors who are independent—i.e. who have no current or past material relationships with the company or its insiders.⁴⁷ The problem is that this narrow definition of independence has led to a “check the box” system of screening for independence which allows boards to engage in formalistic compliance.

46. See, e.g., BERNARD SCHWARTZ, ADMINISTRATIVE LAW § 4.12, at 197 (3d ed. 1991) (“The purpose of the APA [notice-and-comment] rulemaking provision is to give the public an opportunity to participate.”). But see E. Donald Elliott, *Re-Inventing Rulemaking*, 41 DUKE L.J. 1490, 1490 (1992) (arguing that “[n]otice-and-comment does not always provide genuine public participation in legislative rulemaking, it is useful primarily as a record-making device”).

47. See Sarbanes–Oxley Act, 15 U.S.C. § 78j-1 (m) (3) (B) (i) (2012) (defining independence for outside directors on audit committees); Order Approving NYSE & NASDAQ Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. 64,154, 64,157–58 (Nov. 12, 2003) (requiring that NYSE and NASDAQ listed companies have boards of directors with a majority of independent directors and expanding the role of independent directors); NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.02(a) (2013) (“No director qualifies as ‘independent’ unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).”); see also Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act, Pub. L. No. 111-203, §§ 951–54, 124 Stat. 1376, 1899–904 (2010) (codified as amended at 15 U.S.C. §§ 78j–78n) (requiring U.S. public companies to have compensation committees consisting solely of independent directors); Notice of Filing of Amendment No. 3, and Order Granting Accelerated Approval for Proposed Rule Change To Amend the Listing Rules for Compensation Committees To Comply With Securities Exchange Act Rule 10C-1, 78 Fed. Reg. 4570, 4574 (Jan. 22, 2013) (implementing the Dodd–Frank Act independence requirement and stating that to determine director independence boards must consider whether directors received any consulting, advisory, or other fees beyond director fees or have any affiliate relationships with the company).

Corporate boards of directors routinely nominate individuals who have no direct ties to the company but who are part of overlapping circles in the business community and therefore have incentives for deference to management.⁴⁸ While independent directors are intended to serve as a check on management and as shareholder advocates, numerous scholars have documented how independent-director requirements have failed to heighten managerial oversight and accountability.⁴⁹

It is difficult to delineate clear principles to guide a government or independent commission in selecting representative stakeholders. I suggest three options that a government or independent commission should consider to reduce the risk that stakeholders are chosen as rubber stamps for either regulators or industry. First, policymakers could employ a strategy that applies the logic of lead plaintiff selection in securities class action lawsuits to select stakeholders with the highest financial interests at stake who are typical of their class of stakeholder and can adequately represent their category of stakeholder.⁵⁰ Second, policymakers could consider building off of a bankruptcy-creditor committee approach in which a stakeholder regulatory organization would identify categories of stakeholders and work to forge consensus among the different categories of stakeholders.⁵¹ Lastly, policymakers could embrace a representative approach where they identify existing trade associations, industry groups, and shareholder advocacy organizations which would serve as delegates of their members or

48. See, e.g., Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1338–39 (2013) (acknowledging that independent director requirements may not add any value to companies as many boards had a majority of outside directors even before Sarbanes–Oxley and many have had a super-majority of directors since Sarbanes–Oxley).

49. See, e.g., Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002) (arguing that “[t]he conventional wisdom favoring highly independent boards lacks a solid empirical foundation”); Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 131–32 (2010) (arguing that “the independent director’s value has been vastly overstated”); Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. 1375, 1378–79 (2006) (questioning the efficacy of relying on independent directors to police corporate conduct because of the lack of SEC actions against independent directors).

50. See, e.g., David H. Webber, *The Plight of the Individual Investor in Securities Class Actions*, 106 NW. U. L. REV. 157, 160 (2012) (discussing how “the typicality and adequacy of lead plaintiffs is crucial to the legitimacy of class actions, justifying adjudication of the rights of absent parties by assuring that these parties’ interests have been adequately represented by lead plaintiffs who share them.”); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2126 (1995) (arguing that institutional “investors have the knowledge and financial sophistication necessary to serve as effective litigation monitors. Their stake in the outcome of class actions would give them an incentive to do that job well.”).

51. See, e.g., Michelle M. Harner & Jamie Marinic, *Committee Capture? An Empirical Analysis of the Role of Creditors’ Committees in Business Reorganizations*, 64 VAND. L. REV. 749, 757–64 (2011) (providing an overview of the development and roles of creditors’ committees); Kenneth N. Klee & K. John Shaffer, *Creditors’ Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 995, 1001–15 (1993) (discussing the process for the appointment of creditors’ committees).

constituencies.⁵² Each of these strategies entails tradeoffs as it is impossible to have a selection mechanism that fully represents the spectrum of stakeholders or can achieve full consensus. But they each offer a way to approximate representation of a range of interested parties.

The first potential approach would be to apply the logic of lead plaintiff selection in securities class action lawsuits to the stakeholder selection context. The rebuttable presumption in lead plaintiff selection in securities class action litigation is that the entity with the largest financial stake should take the lead in overseeing the suit, so long as their interest is typical of other members of the class, and they can adequately represent the interests of the class.⁵³ This framework could be applied in a broader way to identify representative stakeholders. Policymakers could identify the entities with the largest financial stakes in a given context of financial regulation and use the typicality and adequacy requirement to justify selecting a range of entities that deal with both the demand and supply side of the regulatory area at issue.⁵⁴ For example, in the rating-agency context this approach would suggest focusing on the largest debt issuers and largest institutional investors in rated debt as a starting point in identifying who would best represent stakeholder interests.⁵⁵ Policymakers could use the typicality and adequacy requirements to justify selecting debt issuers and purchasers of rated debt that represent particular slices of the market such as government or corporate debt or particular investor segments such as insurance companies and pension

52. See, e.g., John S. Applegate, *Beyond the Usual Suspects: The Use of Citizens Advisory Boards in Environmental Decisionmaking*, 73 IND. L.J. 903, 921–27 (1998) (discussing the use of advisory groups and stakeholder panels, which include trade associations, to guide environmental regulation decision-making); Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1, 33–36 (1997) (discussing the existing degree of interest group participation in agency decisionmaking and recommending expanded interest group role in agency decisionmaking).

53. See, e.g., 15 U.S.C. § 78u-4(a)(3)(B)(v) (2000) (establishing a rebuttable presumption that the petitioner with the “largest financial interest in the relief” is to be appointed lead plaintiff in securities class action litigation); FED. R. CIV. P. 23(a)(3), (a)(4) (detailing typicality and adequacy requirements for class action representative selection to ensure class members “fairly and adequately protect the interests of the class” and have claims mirroring those of other class members); see also Weiss & Beckerman, *supra* note 50, at 2088–94 (discussing the agency problems that can arise in class actions in the absence of a plaintiff with a sufficient economic interest in the suit).

54. See, e.g., H.R. REP. NO. 104-369, at 34 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 733 (repeatedly referring to expectations that “institutional investors” will take advantage of the lead plaintiff presumption under the Private Securities Litigation Act and take on this role).

55. See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 608 (1990) (arguing that institutional investors will have incentives to exercise oversight roles because of the extent of their holdings).

funds.⁵⁶ The logic would be that Vanguard's experience as one of the largest mutual fund companies may not be typical of all purchasers of rated debt, and so it would be important to include representatives of other categories of purchasers whose interests may diverge from Vanguard's in significant ways.⁵⁷

What is challenging about this approach is that policymakers would have to think through how broadly to define different categories of stakeholders which would be controversial. One danger is that sub-categories of debt purchasers or issuers may claim that they are not being adequately represented in decision-making processes and push for a formal role in decision-making processes. The opposite danger may be institutional investor apathy. This problem has plagued lead plaintiff selection in class action lawsuits.⁵⁸ Institutional investors may not want to put themselves in the middle of regulatory disputes because they want to focus on their core business of investing and do not want to alienate industry actors that they deal with on a regular basis.⁵⁹ For example, institutional investor passivity could lead to debt issuers and rating agencies having more say in a stakeholder regulatory organization either due to limited engagement in decision-making processes by institutional investors or deference to other industry participants. An even more problematic possibility is that institutional investors will largely decline the opportunity to participate in stakeholder regulatory organizations, leaving more politically driven entities such as union pension funds as representatives of debt purchasers.⁶⁰ This result might make it more difficult to achieve consensus and cause stakeholder regulatory organizations to be mired down in political grandstanding between divergent interests.

Policymakers would need to grapple with the decision-making mechanisms within the organization and the question of the degree to which consensus among the various stakeholders is needed to legitimize decisions. Achieving complete consensus among divergent interests would be nearly impossible because of holdout concerns as self-interest could potentially place

56. See, e.g., Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109, 1174–75 (2012) (discussing the virtues of establishing sub-classes in securities class action suits in recognition of diverse interests and preferences).

57. *Id.* at 1152 (discussing how a small number of courts have included lead plaintiffs representing the distinctive institutional and individual investor interests in securities class action litigation).

58. See, e.g., John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1352 (1991) (arguing that the “basic dilemma is that most institutional investors, and particularly those agents that run them, have insufficient interest in exercising ‘voice[]’” in corporate governance and regulatory matters).

59. See, e.g., James D. Cox et al., *There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 366–67 (2008) (providing empirical evidence that institutional investors have been reluctant to take on lead plaintiff responsibilities in the securities class action litigation context).

60. See, e.g., Elliott J. Weiss, *The Lead Plaintiff Provisions of the PSLRA*, 61 VAND. L. REV. 543, 551–52 (2008) (discussing how most of the institutional investors who have taken on lead plaintiff roles for securities class action suits have been public and union pension funds).

industry participants and stakeholders at loggerheads. Instead, it would be more plausible to apply super-majoritarian rules to stakeholder regulatory organization decision-making to ensure that a broad set of stakeholders would need to agree on any decision.⁶¹ The important caveat for a super-majority system is that its efficacy would turn on the weighting of representation of different types of stakeholders. Policymakers would need to establish a framework for representation that would not be skewed in favor of the demand or supply-side of stakeholders or in favor of the primary targets of the stakeholder regulatory organization. The super-majority threshold for decision-making would need to be set high enough to ensure that a broad cross-section of stakeholders, including the targets of regulation, have reached agreement to ensure the legitimacy of rules.

Another important caveat is that regulators would still enjoy the ability to supersede stakeholder regulatory organization's decisions (because the power to regulate practically gives regulators the ability to have the final word on any issue within their jurisdiction).⁶² But achieving a high degree of consensus within stakeholder regulatory organizations would carry significant weight and legitimacy, which would make it difficult for regulators to dismiss their recommendations.⁶³ Selecting stakeholders based on their size, typicality of interest in representing a category of stakeholders, and adequacy in representing their category of stakeholder poses challenges. But this would offer guidance for a government or independent commission to select stakeholders that are broadly representative.

A second potential strategy would be to build off of a bankruptcy creditor committee approach. A government or independent commission could identify categories of stakeholders and design a decision-making process centering on building consensus with a majority of each class of stakeholder.⁶⁴ In bankruptcy, the spectrum of stakeholders in the faltering company have

61. Cf. John O. McGinnis & Michael B. Rappaport, *Our Supermajoritarian Constitution*, 80 TEX. L. REV. 703 (2002) (discussing how the "Constitution embraces super-majority rules as a means of improving legislative decision-making in various circumstances where majority rule would operate poorly").

62. See, e.g., Registration, Responsibilities, and Oversight of Self-Regulatory Organization, 15 U.S.C. § 78s (2011) (detailing the SEC's ability to oversee and reject the decisions of financial self-regulatory organizations); Richard H. Pildes, *Separation of Powers, Independent Agencies and Financial Regulation: The Case of the Sarbanes-Oxley Act*, 5 N.Y.U. J.L. & BUS. 485, 524-25 (2009) (discussing the SEC's ability to reject or amend the decisions of securities' self-regulatory organizations).

63. See John S. Moot, *When Should the FERC Defer to the NERC?*, 31 ENERGY L.J. 317, 325-26 (2010) (discussing the history of SEC deference to self-regulatory organizations).

64. See Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 860-64 (1996) (discussing the conflicts of interest which may arise among creditors as issuers approach insolvency); Elizabeth Warren & Jay Lawrence Westbrook, *Contracting out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197, 1237-38 (2005) (providing empirical data from the bankruptcy context which supports the concern about conflicts of interests among creditors).

seats at the table to lay their claims to assets and must reach consensus to restructure debt. Interested creditors with the largest stakes for each class of secured debt are chosen to serve as creditor committee representatives,⁶⁵ and consensus is needed among each creditor committee for bankruptcy reorganizations to be approved. The logic is simple: the creditors with the most at stake safeguard the interest of those with similar types of claims, and agreement with each class of stakeholders is needed to change creditors' rights to enable bankrupt companies to restructure their debt.

The challenge of applying this framework to the regulatory context is that stakeholders form a much broader category than bankruptcy creditors and shareholders. It would be all but impossible to include all members of the class of stakeholders in a stakeholder committee. Instead, this approach would need to turn on a similar limiting principle as the first approach but with a broader scope. A government or independent commission could identify a group of institutions with the largest financial interests for each category of stakeholders who are both typical of the category of stakeholder and able to adequately represent their interest. The success of this approach would turn on navigating the challenges of determining what categories of stakeholders need to be represented on the demand and supply side to ensure broad-based representation. Another important consideration is determining how many representatives each class of stakeholders should have to make consensus-building manageable within each stakeholder committee.

The advantage of this approach would be that it would facilitate dialogue both among a class of stakeholders and across stakeholders as a whole. While it might be difficult to secure majority consent from each category of stakeholder, a stakeholder regulatory organization could require majority consent from a super-majority of stakeholder committees to agree to a rule. That strategy would ensure that any decision would have substantially broad-based support. This approach would be most plausible in contexts where the regulatory stakes are high enough that they would incentivize broad-based involvement in decision-making processes. The logic is that corporate involvement in stakeholder committees would be a substitute good for lobbying as it would give corporations a chance to frame and address issues before they are addressed by regulators.

Two important concerns would need to be addressed. First, there may be a concern that dialogue about regulatory issues could lead to anti-trust violations and collusion.⁶⁶ While the shadow of anti-trust law may chill the degree of information-sharing and dialogue among corporations within a

65. See 11 U.S.C. § 1102 (2012).

66. See, e.g., Marvin S. Cohen, *Emerging Problems for Future Deregulators*, 53 ANTITRUST L.J. 185, 186 (1984) (discussing the challenges of "accommodat[ing] the cooperative requirements of . . . deregulating industries to the competitive standards of the antitrust law"); Harvey J. Levin, *The Limits of Self-Regulation*, 67 COLUM. L. REV. 603, 618 (1967) (discussing the concern that "antitrust uncertainties necessarily exist in any joint cooperative activity").

given stakeholder committee, this concern should not be overstated as companies routinely work to address common regulatory issues through trade associations and broader business groupings.⁶⁷ Second, there may be a concern that a stakeholder-committee approach would pose significant costs and challenges to secure company involvement that may outweigh any regulatory benefits. Weighing that concern should be central in the decision about whether to embrace this approach. The stakes would have to be high enough to induce corporations to invest significant time and energy in this type of decision-making process.

A third alternative would be to enlist trade associations, industry organizations, and shareholder advocacy groups to represent the range of stakeholders.⁶⁸ Either the relevant government regulator or an independent board could award representation to existing organizations that best reflect different facets of the spectrum of stakeholders. These groups are often already the primary actors lobbying legislators and regulators behind the scenes on financial regulation issues.⁶⁹ Expressly recognizing the role of trade associations or industry groups in a stakeholder regulatory organization would be a way of bringing their advocacy out of the shadows and into dialogue with one another. This approach would leverage existing private associations for a productive purpose. Associations may not always represent intra-industry interests, which can diverge, but they may serve as the closest proxy for industry interests. It is reasonable to believe that different trade associations would exist to represent divergent stakeholder interests as each faction would want its own interests represented in legislative and regulatory processes. The challenge may be finding adequate representation for investors, as the unity of interest among retail investors is often less cohesive than that of stock and debt issuers.⁷⁰

The downside of directly enlisting trade associations, industry groups, and shareholder advocacy groups is that the government would be deputizing lobbying organizations to perform a public function and give them an

67. See, e.g., ARTHUR L. HEROLD & GEORGE D. WEBSTER, *ANTITRUST GUIDE FOR ASSOCIATION EXECUTIVES* 6–7 (2d ed. 1979) (discussing how trade associations monitor their collaborative activities to guard against anti-competitive effects).

68. See, e.g., Freeman, *supra* note 52, at 33–36 (discussing the degree of interest group participation in agency decisionmaking through consultative processes). Group participation also exists in the class action suit context as groups of individuals account for approximately 27% of the lead plaintiffs in securities class action suits. See James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1623 tbl.3 (2006). Enlisting organizations in stakeholder regulatory organizations would take the logic of group representation one step further in recognizing that organizations can serve as proxies of group interests in a stakeholder regulatory organization.

69. See, e.g., Kimberly D. Krawiec, *Don't "Screw Joe the Plummer": The Sausage-Making of Financial Reform*, 55 ARIZ. L. REV. 53, 79–80 (2013) (detailing the role of trade associations in meetings with securities and financial regulators about implementation of the Dodd–Frank Act).

70. See, e.g., Manns, *supra* note 7, at 808 (discussing how investors' interests are fractured).

imprimatur of legitimacy.⁷¹ Enlisting private actors to perform public roles is far from new—as that is the point of rating agencies as gatekeepers.⁷² What is distinctive about this approach is that it calls for relying on private associations to act out of their self-interest in regulatory processes, rather than to put on an ostensibly public hat and relies on the virtues of Madisonian factionalism to avoid regulatory outcomes that favor one part of the financial sector.⁷³ Industry advocates would have every incentive to represent their self-interest well, and the public benefit would lie in the aggregate of each faction representing its interest and working on compromises that further the collective self-interest of affected stakeholders. A skeptic would understandably fear that this approach would be akin to pouring fuel on an existing lobbying fire. But the hope is that bringing the lobbying process out of the shadows and bringing in a range of stakeholders would blunt any single faction's influence.

This approach faces similar challenges as the first two approaches in determining the scope, typicality, and adequacy of representation for categories of stakeholders. While reliance on trade associations and industry groups would make the numbers of stakeholders more manageable, full consensus would still be very difficult, which would suggest the desirability of super-majorities in decision-making to signal broad-based support.

One critique of all three of these approaches is that some regulatory issues may not have a clear resolution, which should serve as a cautionary note on the potential of stakeholder regulatory organizations. For example, the flurry of crisis-related reforms remains a work in progress at the regulator level, and the uncertainties of existing regulations may be a check on further rules and regulations until the implications and unintended consequences of the existing regulatory regimes are more evident. Similarly, some limitations on regulation may be due to genuine uncertainty or stark disagreement concerning how to gauge the performance of financial actors. A stakeholder regulatory organization could take the lead in trying to resolve this type of issue, but it is not clear that such an organization could definitively resolve these types of concern or address them in a way that heightens understandings of risk in financial markets.

The most significant critique of all three of these approaches is that they may end up creating a system of stalemate as stakeholders seek to leverage

71. The legitimization issue is especially important if there are concerns about how representative trade associations and industry groups are of public interests. See, e.g., Susan Rose-Ackerman, *Consensus Versus Incentives: A Skeptical Look at Regulatory Negotiation*, 43 DUKE L.J. 1206, 1210 (1994).

72. See, e.g., Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986) (defining gatekeepers as “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers”).

73. See Cass R. Sunstein, *Interest Groups in American Public Law*, 38 STAN. L. REV. 29, 38–45 (1985) (providing an overview of Madison's constitutional vision of the productive role of faction offsetting faction).

their roles to cripple regulatory proposals that are against their interests. A significant challenge would be to determine how to spur stakeholders to action as there are significant stumbling blocks to collective action and consensus building. As the political class of Washington, D.C., knows all too well, putting adversaries at a negotiating table may simply lead to protracted stalemate and inaction. For example, the 2012 across-the-board sequestration cuts were designed as a default threat to bring the two American political parties together to forge a new budget because the default hurt each party's constituencies. But gridlock lasted for over two years before the two parties reached a budget deal.⁷⁴

In contrast, government regulators would have more potent regulatory tools to incentivize consensus building among private parties. The challenge is that the reciprocal oversight problem suggests that in ordinary circumstances both the government and stakeholders may be reluctant to take action because they are all caught up in the euphoria of an economic boom. But when boom turns to bust, the threat of government action in response to popular pressure would produce incentives for stakeholder regulatory organizations to act.

In the shadow of an economic crisis, agencies could pressure parties to reach agreement on regulatory priorities or face the threat of unilateral government action, which would heighten uncertainty and risk for all concerned. The repeat player nature of regulation means that regulators would have trump cards if particular stakeholders repeatedly appeared to be the stumbling blocks to consensus.⁷⁵ Not only could regulators supersede stalemates or agreements with their own policies, but also they would be able to take into account intransigence into shaping policies for rating agencies and other regulatory spheres affecting stakeholders. The threat of government action would make it more plausible for regulators to push stakeholder regulatory organizations to act on issues of public concern in the wake of a crisis by identifying issues they will potentially act on if stakeholders cannot reach consensus.

Regulators could go a step further and employ a "regulatory default" approach in which they identify potential default rules to set a stakeholder regulatory organization's agenda.⁷⁶ This approach would place the onus on

74. See Jonathan Weisman, *Senate Ends Budget Debate, Clearing Way to Passage*, N.Y. TIMES (Dec. 17, 2013), http://www.nytimes.com/2013/12/18/us/politics/budget-deal.html?_r=0.

75. See Freeman, *supra* note 2, at 548–55 (discussing similar dynamics in "negotiated rulemaking" between regulators and regulated industries).

76. The regulatory default concept has been used in the environmental-law context to provide regulated parties with incentives to produce new information and make the case for alternatives. See, e.g., Karkkainen, *supra* note 9, at 869–70. The dilemma is whether regulators will credibly follow through with default rules if there is no self-regulatory organization decision within the agency's time frame. Cf. Jacob E. Gersen, *Administrative Law Goes to Wall Street: The New Administrative Process*, 65 ADMIN. L. REV. 689, 728–31 (2013) (discussing how statutory deadlines

industry stakeholders to agree on an alternative to forestall a default rule. The key would be to propose rules that place equal burdens on industry participants and stakeholders, which would place pressure on all parties to develop and embrace an alternative. For example, the Securities & Exchange Commission could threaten to impose high registration fees on over-the-counter derivatives to create a pre-funded insurance fund (whose cost would presumably be passed on to end users and thereby limit the scope and size of derivatives) unless the International Swaps and Derivatives Association develops a private alternative. The downside of a regulatory default-rule approach is that stakeholders who stand to gain (or lose less) from the proposed default rule would have incentives to work to undermine compromises without blatantly opposing the process.

Stakeholder regulatory organizations would mitigate, rather than solve the problems that affect both government and self-regulation. In economic booms neither the government nor stakeholders would have incentives to address regulatory problems and overcome collective action problems because prosperity would cloud the realities of risk. But the virtues of the stakeholder regulatory organization would shine the brightest in the context of reactions to future economic crises. In that context governments would have incentives to act to address popular pressure, and the credible threat of government regulation would spur stakeholders to invest time and energy in forging regulatory solutions and overcoming collective action problems. Bringing together a spectrum of stakeholders would make it more likely that solutions would be grounded in the economic realities affecting the stakeholders without being skewed to favor a particular part of the financial sector.

III. THE CASE OF SOVEREIGN RATINGS

The clash between rating agencies and both the United States and European Union governments starkly illustrates the reciprocal oversight problem. The difficulties sovereign ratings pose for both government oversight and self-regulation make rating agencies serve as a good case study for considering the merits of a stakeholder regulatory organization approach.

Rating agencies have long served as convenient scapegoats for sovereign downgrades that reflect years of fiscal mismanagement and growing economic and political risks.⁷⁷ The irony is that the existence of sovereign ratings reflects

for regulators have often proved fruitless because of the absence of any penalty, a fact which has been underscored by regulators' widespread disregard of Dodd-Frank Act deadlines).

77. See, e.g., Panagiotis K. Staikouras, *A Theoretical and Empirical Review of the EU Regulation on Credit Rating Agencies: In Search of Truth, Not Scapegoats*, 21 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 71, 72-73 (2012) (discussing the temptation European politicians and policymakers faced to blame rating agencies for European credit problems); see also Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW.

the need for external accountability of governments' fiscal management.⁷⁸ Politicians in both the developed and developing world have repeatedly demonstrated a remarkable ability to ignore fiscal realities and dissemble until a crisis is at their doorstep. For this reason, markets value sovereign ratings both as proxies on how close governments are to the precipice of a default and as a tool of public pressure for fiscal restraint.⁷⁹

Historically, emerging-market nations have been the primary targets of sovereign downgrades because their development has often followed the pattern of heavily leveraged booms giving way to predictable busts, which reduces emerging-market leaders to impotently condemning rating agencies for downgrades.⁸⁰ In contrast, what is striking about the most recent financial crisis is that the largest developed country and economic bloc—the United States and European Union respectively—were subjected to sovereign ratings downgrades. As the two leading financial regulators, the United States and European Union are better positioned than any other countries to use their economic power and regulatory sway to hold rating agencies accountable.⁸¹ But downgrades of the United States and European Union countries starkly exposed the conflicts of interest created by the reciprocal oversight of governments and rating agencies and undercut the potential for an overhaul of the industry.⁸² Political backlashes to downgrades simultaneously led to

1421, 1428–29 & n.47 (2002) (discussing politicians' attempt to blame rating agencies for the Enron debacle).

78. See António Afonso, Pedro Gomes & Philipp Rother, *Short- and Long-Run Determinants of Sovereign Debt Credit Ratings*, 16 INT'L J. FIN. & ECON. 1, 1–2 (2011) (discussing how sovereign credit ratings serve as “a condensed assessment of a government’s ability and willingness to repay its public debt on time” and are pivotal for default probability analysis); Mitu Gulati & George Triantis, *Contracts Without Law: Sovereign Versus Corporate Debt*, 75 U. CIN. L. REV. 977, 985 (2007) (discussing how markets use sovereign bond ratings as proxies of a country’s financial stability).

79. See, e.g., Constantin Mellios & Eric Paget-Blanc, *Which Factors Determine Sovereign Credit Ratings?*, 12 EUR. J. FIN. 361, 361–62 (2006) (describing how sovereign credit ratings affect financial markets); David Oakley & Peter Wise, *Portuguese Bonds Hit as Traders Fear Default*, FIN. TIMES (Jan. 26, 2012), <http://www.ft.com/intl/cms/s/o/49916f7a-468a-11e1-89a8-00144feabdco.html#axzz3S15oqCvU> (discussing the market reaction to the downgrade of Portugal and Greece to junk bond status).

80. See Steven A. Block & Paul A. Vaaler, *The Price of Democracy: Sovereign Risk Ratings, Bond Spreads, and Political Business Cycles in Developing Countries*, 23 J. INT'L MONEY & FIN. 917, 918–22 (2004) (discussing economic, political, and legal factors that shape sovereign risk in developing countries).

81. The United States and the European Union remain the dominant economic powers with estimated 2013 GDPs of \$16.720 trillion and \$15.850 trillion respectively. *The World Factbook: Country Comparison: GDP (Purchasing Power Parity)*, CENT. INTELLIGENCE AGENCY, <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html?countryname=EuropeanUnion&countrycode=ee®ioncode=eur&rank=2#ee> (last visited Mar. 23, 2015). But the United States and Western Europe play a far larger role in capital markets and account for 31.9% and 30.1% of world markets, respectively, in 2010. See CHARLES ROXBURGH, SUSAN LUND & JOHN PIOTROWSKI, *MAPPING GLOBAL CAPITAL MARKETS 2011*, at 24 (2011).

82. An extensive literature has debated the scope and potential remedies for the shortcomings of the issuer-pays system for rating agencies. See, e.g., Lynn Bai, *The Performance*

calls for rating-agency regulation and cast a pall over the reform process.⁸³ Both the United States and European Union are conflicted by their desire to downplay risks to state finances and the broader economy, which dampened incentives to create a system of truly timely and accurate ratings. Rating agencies recognize they must tread carefully with sovereign ratings for fear of political backlashes and economic fallout, yet sovereign ratings give rating agencies a trump card to push back against government regulation.

The financial crisis should have been a catalyst for comprehensive rating-agency reforms given the role of rating agencies in understating risks in the structured finance products that fueled the financial crisis.⁸⁴ Governments on both sides of the Atlantic took steps to address the worst excesses of rating agencies in the run up to the financial crisis and took on the role of primary regulators of rating agencies. But reforms were watered down due in part to governments' conflicts of interest. While public pressure for rating-agency accountability led to some reforms and litigation, it did not change the fact that governments have incentives to tolerate, if not embrace, systematically lax ratings to obscure their own fiscal shortcomings and their economy's broader issues.

The irony is that rating agencies' and governments' incentives generally converge to engage in deferential ratings to both public and private issuers, rather than to produce timely and accurate ratings. This strategy is designed to attract more business from issuers and to mitigate the risk of regulation as governments have little interest in interfering with financial markets during

Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?, 7 N.Y.U. J.L. & BUS. 47, 97–98 (2010) (arguing for the need for standardization of rating-agency performance statistics to facilitate comparability); Jonathan M. Barnett, *Intermediaries Revisited: Is Efficient Certification Consistent with Profit Maximization?*, 37 J. CORP. L. 475, 501–02 (2012) (arguing in favor of greater regulatory oversight as preferable to potentially counter-productive efforts at fostering greater competition); Coffee, *Ratings Reform*, *supra* note 7, at 232–36 (advocating the abolition of the issuer-pays system and analyzing the merits of the potential alternatives for heightened public regulation); Milosz Gudowski, *Mortgage Credit Ratings and the Financial Crisis: The Need for a State-Run Mortgage Security Credit Rating Agency*, 2010 COLUM. BUS. L. REV. 245, 264–71 (advocating a government utility model for ratings); Yair Listokin & Benjamin Taibleson, Essay, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91, 94–95 (2010) (arguing that compensating rating agencies with the debt proceeds they rate would create greater incentives for rating accuracy); Manns, *supra* note 34, at 1015–19 (calling for a user fee on investors to finance the creation of an independent board to select and compensate rating agencies based on a competitive bidding process). In contrast, this Article is the first to identify and address the reciprocal oversight problem for sovereign ratings. Sovereigns are conflicted in ratings reform because of their desire to downplay their financial imbalances, while rating agencies have incentives to leverage sovereign ratings to push against ratings reforms.

83. See, e.g., Aline Darbellay & Frank Partnoy, *Credit Rating Agencies Under the Dodd–Frank Act*, 30 BANKING & FIN. SERVICES POL'Y REP. 1, 1 (2011) (discussing how European Union leaders blamed rating agencies for exacerbating the debt crisis when Greek downgrades occurred before the unveiling of a bailout plan).

84. See, e.g., CHARLES A.E. GOODHART, *THE REGULATORY RESPONSE TO THE FINANCIAL CRISIS* 121–22 (2009) (discussing the role that high fees for structured finance products played in inflating ratings).

financial upswings.⁸⁵ The financial crisis disturbed this equilibrium as public pressure for ratings reform clashed with a deteriorating sovereign risk environment. Rating agencies could plausibly claim that sovereign downgrades were a response to pressure for more timely and accurate ratings, and the threat of further downgrades paradoxically both sparked outrage yet dampened incentives for governments to follow through on comprehensive rating-agency reforms.

A. *THE INHERENT DISCRETION IN SOVEREIGN RATINGS*

The reciprocal oversight problem has long been overshadowed by the issuer-pays conflict of interest. An inherent conflict of interest exists from issuers hiring and paying rating agencies.⁸⁶ Rating agencies have incentives to *till* ratings in favor of issuers for fear of biting the hands that feed. Rating agencies face reputational constraints, yet the pressure to woo and retain clients' business creates stronger incentives to defer to issuers.⁸⁷ This conflict increases the more opaque the financial instrument. The less transparency, the easier it is for issuers and rating agencies to water down standards without markets recognizing the decline.⁸⁸ For example, empirical studies have documented that ratings inflation steadily increased as structured finance products became more complicated in the run up to the financial crisis.⁸⁹

However, the issuer-pays conflict of interest does not literally apply for sovereign ratings because these ratings are frequently unsolicited and

85. See Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 342-43 (2003) (discussing the reluctance of rating agencies to downgrade their issuer clients because of concerns about the far-reaching effects of downgrades).

86. See Coffee, *Ratings Reform*, *supra* note 7, at 233-36 (advocating the abolition of the issuer-pays system).

87. See Manns, *supra* note 34, at 1049-50 (discussing the shortcomings of reputational constraints).

88. See Bai, *supra* note 82, at 63-66 (discussing how the degree of opaqueness of rated products can foster ratings inflation).

89. See, e.g., ADAM ASHCRAFT, PAUL GOLDSMITH-PINKHAM & JAMES VICKERY, FED. RESERVE BANK OF N.Y., *MBS RATINGS AND THE MORTGAGE CREDIT BOOM* 23-24, 44 fig.3 (2010), available at http://www.newyorkfed.org/research/staff_reports/sr449.pdf (documenting a pattern of stability in high ratings in spite of declines in diligence of and asset quality in mortgage-backed securities from 2001 to 2008); Efraim Benmelech & Jennifer Dlugosz, *The Alchemy of CDO Credit Ratings*, 56 J. MONETARY ECON. 617, 624-28, 632-33 (2009) (criticizing the lax process for the credit rating of CDOs and the conflicts of interest created by the hiring of rating agencies by issuers); Jennifer E. Bethel, Allen Ferrell & Gang Hu, *Law and Economic Issues in Subprime Litigation Arising from the 2007-2008 Credit Crisis* 16-18, 21, 74 (John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 612, 2008) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1096582 (documenting the stability of ratings in spite of marked decline in the extent of diligence into and quality of the underlying mortgages in mortgage-backed securities from 2001 to 2006).

unpaid.⁹⁰ For example, the United States federal government does not select or pay rating agencies to issue ratings on federal debt. Instead, they provide sovereign ratings as a public good which gives them a high-profile accountability role that complements their profitable business for private issuers and state and local governments.⁹¹ But a similar opaqueness problem that arises in the issuer-pays conflict of interest context manifests itself in sovereign ratings. Rating agencies enjoy great discretion to determine sovereign ratings because of the distinctive nature of the risks and strengths of sovereign states.⁹² Part of this discretion is necessary given the nature of ratings as long-term assessments of credit risk.⁹³ It is one matter to predict the potential default rate of bundles of mortgages even if there are significant uncertainties about the quality of the underlying mortgages. It is another to capture precisely the complex web of interconnected risks that sovereign states face. Policymakers in the United States and European Union similarly failed to understand the scope of public risk during the financial crisis, so rating agencies can hardly be blamed for having significant wiggle room to grapple with these uncertainties.⁹⁴

The danger is that rating agencies will exploit the ambiguity of sovereign ratings to stretch their power or to deter meaningful regulatory reforms. Rating agencies can leverage opaqueness to legitimize risk taking during boom periods by understating risks or by threatening sovereign downgrades when busts occur and pressures for regulation rise.⁹⁵ Standard & Poor's ("S&P") sovereign rating methodology is indicative of the flexibility rating agencies enjoy in assessing sovereign ratings. S&P lends the appearance of mathematical precision to their method by translating qualitative criteria into quantitative metrics. Analysts compile five sets of scores that cover institutional and governance effectiveness, economic structure and growth prospects, external liquidity and international investments, fiscal performance and flexibility, and monetary flexibility.⁹⁶

90. See EUROPEAN SEC. & MKTS. AUTH., CREDIT RATING AGENCIES: SOVEREIGN RATINGS INVESTIGATION 4 (2013).

91. See Ashok Vir Bhatia, *Sovereign Credit Ratings Methodology: An Evaluation* 47 (Int'l Monetary Fund, Working Paper No. 02/170, 2002) (discussing the publicity that rating agencies gain from sovereign ratings); see also Manns, *supra* note 34, at 1056–57 (discussing the role of ratings as public goods).

92. See Christopher M. Bruner, *States, Markets, and Gatekeepers: Public-Private Regulatory Regimes in an Era of Economic Globalization*, 30 MICH. J. INT'L L. 125, 136–38 (2008) (discussing the “lack of objective metrics of creditworthiness” for sovereign ratings).

93. See MOODY'S INVESTORS SERV., MEASURING THE PERFORMANCE OF CORPORATE BOND RATINGS 7, 15 (2003) (discussing the emphasis on long-term concerns in determining ratings through the process of “fundamental credit analysis”).

94. See Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. U. L. REV. 127, 169 (2009) (discussing the failure of private and public risk models to predict the scope and scale of the financial crisis).

95. See Manns, *supra* note 7, at 754–58.

96. See S&P Sovereign Rating, *supra* note 6, at 3–34.

Each of these factors offers a legitimate lens to analyze the default risk of sovereign states. But the numerical scoring obscures the degree of discretion analysts have in establishing the scores. Determining factors such as political risk, economic growth prospects, and fiscal performance and flexibility entail exercises of extraordinary discretion and take place in the shadow of the need for sensitivity to the political and economic fallout of downgrades. This discretion is all the more significant because rating agencies purport to focus on the long-term structural creditworthiness of sovereigns. Long-term assessments inevitably entail greater degrees of discretion and uncertainty than short-term determinations as part of the analysis is by definition at best informed conjecture.⁹⁷ For example, credit prospects for countries may be inherently more difficult to predict for countries compared to corporations because of the impact of elections in changing fiscal and economic policies.

Historically, analysts have used this discretion to tilt sovereign ratings in favor of governments, which reflects both the systematic advantages sovereigns have over private actors in meeting liquidity needs and the danger of provoking government regulation. For example, S&P's fundamental credit analysis is designed to provide a long-term assessment of risk and expressly prioritizes sovereign rating-stability over reactions to short-term market changes.⁹⁸ S&P's own data indicates that sovereigns enjoy systematically higher ratings than their private counterparts.⁹⁹ S&P's defense of its sovereign ratings lies in the low default rates compared to other types of issuers, as in the past 40 years only a small percentage of investment-grade sovereigns have defaulted.¹⁰⁰

Deferential sovereign ratings are partly understandable because of the unique ability of sovereigns to meet bond obligations by printing money or raising taxes. But the other part of the equation is that sovereign states enjoy the unique ability to push back at rating agencies through exercising regulatory powers. While emerging market countries may have a limited ability to regulate rating agencies directly, even they can complicate the ability of rating agencies to do business in their countries. But the United States and the European Union are potentially more formidable foes because they can impose regulations that significantly affect rating agencies' business model and profitability. This fact raises the question of what changed during the

97. See Ulrich K. Müller & Mark W. Watson, *Measuring Uncertainty About Long-Run Predictions* 1–2 (Nat'l Bureau of Econ. Research, Working Paper No. 18870, Mar. 2013), available at <http://www.nber.org/papers/w18870.pdf> (discussing the challenges in quantifying the uncertainty in long-run predictions of economic variables).

98. See S&P Sovereign Rating, *supra* note 6, at 3–34.

99. *Id.* at 4 (“Since 1975, 15-year cumulative default rates for sovereigns averaged 2.5% for investment-grade sovereigns and 24.8% for speculative-grade sovereigns.”).

100. *Id.* (“At year-end 2012, almost 11% of our sovereign local- and foreign-currency ratings were ‘AAA’ and roughly 15% were in the ‘AA’ category, compared with about 0.3% and 5%, respectively, for private-sector issuers.”).

financial crisis that unsettled a status quo in which rating agencies had incentives to be deferential to sovereigns.

B. *THE CLASHES BETWEEN RATING AGENCIES AND THE U.S. AND E.U.*

Rating-agency and government recklessness unsettled the equilibrium of deferential ratings and set the leading rating agencies on a collision course with United States and European Union regulators. Many actors deserve blame for fueling excessive risk taking through the design of trillions of dollars of structured-finance products that intentionally camouflaged substantial risks.¹⁰¹ But rating agencies merit particular blame because a myriad of statutes and regulations in the United States and European Union deputized rating agencies as gatekeepers of credit risk.¹⁰² Rating agencies not only failed to identify financial risks in an accurate and timely way, but also legitimized the proliferation of deceptive financial instruments through issuing inflated ratings. As a result, rating agencies failed to identify increasing risks or to condition ratings on adequate diligence and disclosures by issuers.¹⁰³

The enormity of the financial crisis, coupled with the degree of rating agencies' culpability,¹⁰⁴ made rating-agency accountability a priority for

101. Residential Mortgage-Backed Securities ("RMBS") and Mortgage-Based Collateralized Debt Obligations ("CDO") are debt obligations based on large pools of mortgage loans whose cash flows derive from principal and interest payments from the underlying mortgages. See *Mortgage-Backed Securities*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/mortgage_securities.htm (last visited Mar. 23, 2015). Approximately \$1.7 trillion in subprime RMBS were issued from 2001 to 2006. See ADAM B. ASHCRAFT & TIL SCHUERMANN, FED. RESERVE BANK OF N.Y., UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 2 (2008). JP Morgan has estimated that \$500 to \$600 billion in subprime CDOs were issued over this period. See Jenny Anderson & Heather Timmons, *Why a U.S. Subprime Mortgage Crisis Is Felt Around the World*, N.Y. TIMES (Aug. 31, 2007), <http://www.nytimes.com/2007/08/31/business/worldbusiness/31derivatives.html>; see also Crouhy, Jarrow & Turnbull, *supra* note 16, at 8–19 (discussing the array of market participants who have potential culpability for the subprime mortgage crisis).

102. See, e.g., Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, § 4, 120 Stat. 1327, 1329–33 (codified as amended at 15 U.S.C. § 780-7) (amending the Securities Exchange Act of 1934 by inserting a new section: 15E, which lays out the process by which rating agencies can be certified as Nationally Recognized Statistical Rating Organizations ("NRSRO")); Regulation S-K, 17 C.F.R. § 229.10(c) (2014) (mandating the inclusion of ongoing NRSRO ratings for issuers making filings under the Securities Act of 1933 and the Securities Exchange Act of 1934); see also Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, 68 Fed. Reg. 35,258, 35,258 (June 12, 2003) [hereinafter SEC Concept Release] (discussing how "[s]ince 1975, the [SEC] has relied on credit ratings from market-recognized credible rating agencies for distinguishing among grades of creditworthiness in various regulations under the Federal securities laws").

103. See Manns, *supra* note 7, at 754–58.

104. See, e.g., Vikas Bajaj & Mark Landler, *Mortgage Losses Echo in Europe and on Wall Street*, N.Y. TIMES (Aug. 10, 2007), <http://www.nytimes.com/2007/08/10/business/10markets.html> (discussing the scale of subprime mortgage CDO exposure facing banks and other creditors); Jody Shenn & David Mildeberg, *Subprime, CDO Bank Losses May Exceed \$265 Billion (Updates)*, BLOOMBERG (Jan. 31, 2008, 3:46 PM), http://www.bloomberg.com/apps/news?sid=aCtr4_6Nd

American and European policymakers.¹⁰⁵ The problem is that government responses to the financial crisis exposed the United States and European Union member-states to potential sovereign rating downgrades which sparked clashes between governments and rating agencies. Governments on both sides of the Atlantic sought to mitigate the financial crisis by stabilizing the banking sector through internalizing the costs and risks of the financial sector's failures.¹⁰⁶ This nationalization of financial risk-taking led to predictable results of governments' overstretching their balance sheets and facing sovereign rating downgrades.¹⁰⁷ This fact led to a stark illustration of the reciprocal oversight conflict of interest. Governments grappled with the need to regulate rating agencies to avoid a repeat of the conditions that led to the financial crisis, while also seeking to deter rating agencies from issuing sovereign rating downgrades. Rating agencies tacitly leveraged their sovereign ratings power to push back at regulatory reforms.

Both European Union and United States rating-agency reforms occurred roughly contemporaneously with the Dodd–Frank Act of 2010 in the United States and the 2009 CRA Regulation in the European Union (which was amended in 2011 and 2013).¹⁰⁸ Most of rating-agency reform was broad in scope but limited in impact. The defining theme of both American and European ratings reforms is their convergence on a set of conflicting, inadequate approaches. Both American and European reforms centralized oversight in a federal regulator (the Securities & Exchange Commission (“SEC”) and European Securities & Markets Authority (“ESMA”), respectively) and laid out registration requirements to ensure the independence and integrity of the ratings process. But regulators spoke out

Xdw&pid=newsarchive (discussing how “[a]lmost half the subprime bonds rated by [Standard & Poor’s] in 2006 and early 2007 were cut or placed on review” for ratings downgrades in 2008, a fact which suggests rating agencies’ lax approach).

105. See, e.g., U.S. SEC. & EXCH. COMM’N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 1–2 (2008) (discussing the shortcomings of rating agencies’ policies and procedures, internal audit processes, and surveillance of complex RMBS and CDOs); U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE: MAJORITY AND MINORITY STAFF REPORT 272 (2011) [hereinafter WALL STREET REPORT] (discussing “the fact that the rating agencies issued inaccurate ratings” and the role of “conflicts of interest inherent in the ‘issuer-pays’ model” in rating-agencies’ failures (emphasis omitted)).

106. See Caroline Jensen, *What Doesn’t Kill Us Makes Us Stronger: But Can the Same Be Said of the Eurozone*, 46 INT’L LAW 759, 761–63 (2012) (discussing the unsustainable debt Eurozone countries have taken on due to bailouts of its weaker members and their banking sectors).

107. See COMM. ON THE GLOBAL FIN. SYS., BANK FOR INT’L SETTLEMENTS, THE IMPACT OF SOVEREIGN CREDIT RISK ON BANK FUNDING CONDITIONS 20–23 (2011).

108. See Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, 15 U.S.C.); Commission Regulation 462/2013, 2013 O.J. (L 146) 1 [hereinafter CRA Regulation III]; Commission Regulation 513/2011, 2011 O.J. (L 145) 30 [hereinafter CRA Regulation II]; Commission Regulation 1060/2009, 2009 O.J. (L 302) 1 [hereinafter CRA Regulation I].

of both sides of their mouth in trying to marginalize ratings by rolling back requirements for ratings,¹⁰⁹ while underscoring the importance of rating agencies by seeking to heighten transparency,¹¹⁰ as well as asserting regulatory controls and private oversight to heighten accountability.¹¹¹ These strategies signaled regulators' determination to reign in the ratings industry, yet failed both individually and collectively to transform the industry.

The logic of rolling back government requirements for ratings was that governments had legitimized the reliance on ratings, and abolishing requirements would end the public endorsement of private proxies of credit risk.¹¹² American regulators replaced requirements for ratings with language requiring investors to consider the creditworthiness of securities independently from ratings.¹¹³ Both European and American regulatory bodies were required to review and remove most references to rating agencies and to develop their own broader standards of creditworthiness to supplant the role of ratings.¹¹⁴ But in spite of trans-Atlantic efforts to reduce reliance on ratings, markets and many government agencies have indicated that they will continue to rely on ratings as proxies for credit risk for the foreseeable future because of the absence of credible alternatives.¹¹⁵ Decades of

109. See, e.g., Mark J. Flannery et al., *Credit Default Swap Spreads as Viable Substitutes for Credit Ratings*, 158 U. PA. L. REV. 2085, 2086–89 (2010) (arguing for a shift to reliance on credit default swap spreads to serve as a proxy of creditworthiness); Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA. L. & BUS. REV. 10, 21–24 (2006) (advocating marginalizing credit ratings because they provide “no information of value to the investing public”); Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis* 1–2 (Univ. of San Diego Sch. of Law, Research Paper No. 09-015, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1430653 (advocating the abolition of government-mandated requirements for rating because “[a] primary cause of the recent credit market turmoil was overdependence on credit ratings and credit rating agencies”).

110. See, e.g., Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111, 1144–50 (2009) (arguing for greater rating-agency disclosures and expanded SEC disciplinary and sanctions power).

111. See, e.g., Bai, *supra* note 82, at 97–98; Barnett, *supra* note 82, at 501–02; Coffee, *Ratings Reform*, *supra* note 7, at 233–36; Gudzowski, *supra* note 82, at 264–71; Listokin & Taibleson, *supra* note 82, at 94–95; Manns, *supra* note 34, at 1015–19.

112. U.S. regulators stated that the premise of these changes is to make clear that investors should not “place undue reliance on the NRSRO ratings.” See References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,088, 40,099 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts. 240, 242, 249); CRA Regulation III, *supra* note 108, art. 5b (making a similar point to justify European Union regulators' removal of requirement for ratings).

113. See Dodd–Frank Act § 939 (codified as amended at scattered sections of 12, 15 U.S.C.); see also 12 U.S.C. § 1817 (2012).

114. See Dodd–Frank Act § 939A (codified as amended at 15 U.S.C. § 780-7 (2012)); CRA Regulation III, *supra* note 108, art. 5b (mandating that European regulators “shall review and remove, where appropriate, all such references to credit ratings in existing guidelines and recommendations”).

115. See, e.g., Letter from Martin J. Gruenberg, Acting Chairman, Fed. Deposit Ins. Corp., to Harry Reid, Majority Leader, U.S. Senate (July 27, 2011), available at <http://www.fdic.gov/regulations/reform/LA11-NO117.pdf> (discussing how efforts to come up with alternatives for

government requirements for ratings made ratings a virtual necessity, and market practices are now so deeply entrenched that the removal of government mandates has had little impact.¹¹⁶

Both the United States and European Union governments also placed faith in a passive securities regulation approach, which sought to use transparency and procedural requirements to facilitate public and private monitoring.¹¹⁷ Statutes on both sides of the Atlantic expressly bar regulators from shaping the methodologies of rating agencies.¹¹⁸ Instead, the focus on transparency is designed to ensure rating agencies consistently apply their methodologies. Both European Union and American regulators have demanded rating agencies issue annual reports detailing compliance with their own ratings methodologies, internal controls, and regulatory obligations.¹¹⁹

Rating agencies must publicly disclose the qualitative and quantitative methods for each rating, methodological changes, procedures for determining the likelihood of defaults, and significant errors.¹²⁰ Both American and European regulators created requirements for compliance with internal controls to ensure consistent application of ratings methodologies and rating symbols, as well as separation of the business and analyst sphere.¹²¹

Regulators also specified disclosures to make it easier for ratings users to gauge the performance of ratings as well as to understand the nature and

reliance on credit ratings is a work in progress because “[i]dentifying alternatives to credit ratings that are suitable for regulatory capital determinations is challenging and involves policy tradeoffs”); *see also* BASEL COMM. ON BANKING SUPERVISION, BASEL III (2010), *available at* http://www.bis.org/publ/bcbs189_dec2010.pdf (retaining the use of ratings to assess credit and market risk).

116. *See* David S. Hilzenrath, *SEC Poses Plan to Curb Reliance on Credit Ratings, but Regulators Cite Difficulties*, WASH. POST (Apr. 27, 2011), http://www.washingtonpost.com/business/economy/sec-poses-plan-to-curb-reliance-on-credit-ratings-but-regulators-cite-difficulties/2011/04/27/AFv2ypoE_story.html.

117. *See, e.g.*, Dodd–Frank Act § 938 (codified as amended at 15 U.S.C. § 780-8) (establishing a system of universal rating symbols).

118. *See* CRA Regulation I, *supra* note 108, at art. 23(1) (prohibiting member states and regulators from “interfer[ing] with the content of credit ratings and methodologies”); *see also* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified as amended at scattered sections of 15 U.S.C.).

119. *See* PRICEWATERHOUSECOOPERS LLP, A CLOSER LOOK: THE DODD–FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: IMPACT ON CREDIT RATING AGENCIES 3 (2010), *available at* <http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/closer-look-credit-rating-agencies.pdf>; *see also* Dodd–Frank Act § 932(a).

120. *See* Dodd–Frank Act § 932 (codified as amended at 15 U.S.C. § 780-7).

121. *See id.* (requiring board of director approval of the qualitative and quantitative approaches used in rating methodologies); CRA Regulation I, *supra* note 108, annex I, sec. D, pt. I (detailing rating-agency disclosures mandated by the European Union); *id.* annex I, sec. D, pt. II (detailing the additional information that rating agencies must disclose for structured finance products in the European Union).

limits of ratings. Rating agencies must disclose the initial ratings and changes in ratings for each rated security to facilitate comparisons across rating agencies.¹²² In addition, rating agencies must periodically disclose information that indicates the degree of accuracy of past ratings.¹²³ For example, the European Union mandates semi-annual disclosure of rating performance by category compared to historical default rates.¹²⁴ The European Union requires rating agencies to disclose this information to ESMA's centralized European Rating Platform to facilitate users' comparisons of ratings' accuracy over time.¹²⁵

European regulators required disclosure of clients contributing five percent or more of rating-agencies' revenue, the identity of the agencies' 20 largest clients, disclosure of fees and rating pricing, conflicts of interest, and compensation structures.¹²⁶ American rating-agency reforms placed a greater emphasis on corporate-governance controls. Half of rating-agency board of directors must consist of independent directors,¹²⁷ and boards are tasked with oversight of ratings methodologies, accuracy, internal controls, and conflicts of interest.¹²⁸ While these strengthened internal controls and heightened transparency are all positive corporate governance steps, it is unclear whether any of these measures do much to address the challenges facing rating agencies.¹²⁹ The problem is that these reforms only skirt the deeper issues of rating agencies' incentives and ability to gauge risks in a timely and accurate way and the domination of the industry by three firms.

C. RESISTANCE TO TRANSFORMING RATING AGENCIES INTO A REGULATED INDUSTRY

In spite of efforts to rescind ratings requirements and rely on greater transparency, the primary impact of ratings reforms was to move the rating-agency industry closer to becoming a regulated industry with centralized oversight by the SEC and ESMA respectively.¹³⁰ Most of the rating-agency reforms were benign (if unlikely to have a significant impact) and excited little controversy from rating agencies or the general public. But attempts to transform rating agencies into a regulated industry attracted significant opposition from rating agencies and sparked tit-for-tat clashes between rating

122. See Dodd-Frank Act § 932 (codified as amended at 15 U.S.C. § 780-7).

123. See *id.*

124. See CRA Regulation I, *supra* note 108, annex I, sec. E, pt. II.

125. See CRA Regulation III, *supra* note 108, art. 11a.

126. See CRA Regulation I, *supra* note 108, art. II; *id.* annex I, secs. B, E; CRA Regulation III, *supra* note 108, annex I, secs. (1)(d)-(e).

127. See Dodd-Frank Act § 932.

128. See *id.*

129. See, e.g., Fairfax, *supra* note 49, at 131-32 (arguing "that the independent director's value has been vastly overstated"); Sale, *supra* note 49, at 1378-79 (questioning the efficacy of relying on independent directors to police corporate conduct because of the lack of SEC actions against independent directors).

130. See Dodd-Frank Act. § 932 (centralizing oversight in the SEC's Office of Credit Ratings).

agencies, the United States, and the European Union governments. The irony is that both governments and rating agencies could plausibly claim to be doing their job and even performing duties that were long overdue. But the overlap of ratings reforms and sovereign downgrades highlighted the reciprocal oversight problem and ultimately exposed the lack of wherewithal for governments to follow through on the most significant reforms.¹³¹

In the United States the two most significant parts of rating-agency reform elicited clashes from rating agencies, which led the federal government to back down. The first clash was the most visible and dramatic. Part of the Dodd–Frank Act called for exposing rating agencies to civil liability for fraud in securities lawsuits if their ratings were knowingly or recklessly inaccurate.¹³² The leading rating agencies immediately struck back through blatant civil disobedience. To evade potential liability, they threatened to freeze the markets for asset-backed securities by refusing to allow their ratings to be quoted in issuers’ SEC filings. The SEC quickly caved and suspended the rule and stripped the one significant means of private accountability from the Dodd–Frank Act.¹³³

Meanwhile, the leading rating agencies fought a guerrilla campaign of behind-the-scenes lobbying and more subtle public actions to weaken the SEC’s efforts to implement the other significant part of the Dodd–Frank Act: the Franken Amendment. The Franken Amendment mandated that the SEC devise an alternative to the issuer-pays conflict of interest that incentivized deferential ratings for issuers.¹³⁴ The initial version of the Franken Amendment sought to transform rating agencies fully into a regulated industry by calling for the creation of an independent commission to select rating agencies for structured finance products using a lottery or random assignment system with an eventual transition to performance-based selection. But rating-agency opposition led to a watering down of the proposal in the final legislation into a mandate that the Government Accountability Office (“GAO”) and the SEC conduct a series of studies over two years to consider the Franken Amendment and other alternatives for the current issuer-pays system.¹³⁵ The SEC had to implement the Franken Amendment’s

131. The Dodd–Frank Act also lowered the pleading standards for Rule 10b-5 antifraud liability. While significant in theory, in practice the expanded pleading opportunities are unlikely to increase private litigation in any significant way because rating agencies effectively have a safe harbor of due-diligence compliance. *Compare* 15 U.S.C. §§ 77k(b)(3)(C), 78j-1 (2006), *and* 17 C.F.R. § 240.10b-5 (2008), *with* Dodd–Frank Act § 933 (codified as amended at 15 U.S.C. § 780-7(m)).

132. *See* Dodd–Frank Act § 939G.

133. *See* Gretchen Morgenson, *Hey, S.E.C., That Escape Hatch Is Still Open*, N.Y. TIMES (Mar. 5, 2011), <http://www.nytimes.com/2011/03/06/business/06gret.html> (describing the rating agencies’ reaction to the possible imposition of expert liability).

134. *See* Dodd–Frank Act § 939F (codified as amended at 15 U.S.C. § 780-9).

135. *Id.* §§ 939D, 939F (codified as amended at 15 U.S.C. § 780-9).

proposal “unless the Commission determines that an alternative system would better serve the public interest and the protection of investors.”¹³⁶

While the GAO and SEC conducted three studies and held a day of expert panels,¹³⁷ the resulting reports raised the pros and cons of the potential alternatives to the issuer-pays system, rather than recommended concrete action.¹³⁸ The SEC simply ignored the mandate to craft an alternative to the issuer-pays system.¹³⁹ While the SEC detailed some of the practical stumbling blocks to overhauling the issuer-pays system, part of the story of regulatory inaction appears due to the public and behind-the-scenes clash between rating agencies and the federal government.

The high-profile downgrade of the federal government’s credit rating in August 2011 was the clearest example of the larger struggle between rating agencies and the federal government.¹⁴⁰ S&P took advantage of a budget stalemate to downgrade the federal government, which led to an immediate market reaction. All three of the leading rating agencies engaged in muscle flexing by openly criticizing the federal government’s fiscal policies.¹⁴¹ The increased scrutiny of the federal government’s credit rating can be interpreted as a shot over the bow that underscored the ability of rating agencies to affect the United States and world markets. The brilliance of this strategy is that no one could fault rating agencies for being more proactive and timely in their ratings, as that was an objective of the Dodd–Frank Act.¹⁴²

Then Treasury Secretary Timothy Geithner allegedly threatened S&P’s chairman with retaliation if S&P downgraded the federal government—a potentially blatant abuse of government power.¹⁴³ But while there was no official retaliation, the quip that revenge is a dish best served cold was borne out two years later by the Department of Justice’s subsequent civil suit against

136. *Id.* § 939F.

137. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-240, CREDIT RATING AGENCIES: ALTERNATIVE COMPENSATION MODELS FOR NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 8–14 (2012), available at <http://www.gao.gov/products/GAO-12-240>; U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-10-782, SECURITIES AND EXCHANGE COMMISSION: ACTION NEEDED TO IMPROVE RATING AGENCY REGISTRATION PROGRAM AND PERFORMANCE-RELATED DISCLOSURES 79–93 (2010), available at <http://www.gao.gov/products/GAO-10-782>.

138. See SEC. & EXCH. COMM’N, REPORT TO CONGRESS ON ASSIGNED CREDIT RATINGS 72–82 (2012), available at <http://www.sec.gov/news/studies/2012/assigned-credit-ratings-study.pdf>.

139. See David Dayen, *Financial Reform’s Triple “F” Rating*, AM. PROSPECT (Feb. 21, 2013), <http://prospect.org/article/financial-reforms-triple-f-rating>.

140. See Damian Paletta & Matt Phillips, *S&P Strips U.S. of Top Credit Rating*, WALL ST. J. (Aug. 6, 2011, 1:01 AM), <http://www.wsj.com/articles/SB20001424053111903366504576490841235575386>.

141. See, e.g., Damian Paletta, *Rating Agencies Inch Closer to Historic Downgrade of U.S. Debt*, WALL ST. J. WASH. WIRE (July 14, 2011, 9:02 PM), <http://blogs.wsj.com/washwire/2011/07/14/rating-agencies-inch-closer-to-historic-downgrade-of-u-s-debt/>.

142. See Manns, *supra* note 7, at 754–58.

143. See Hope & Paletta, *supra* note 5.

S&P, resulting in a \$1.37 billion settlement.¹⁴⁴ In February 2013, the Department of Justice singled S&P out in a lawsuit alleging fraud in asset-backed securities ratings based on a rarely used anti-fraud provision of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”).¹⁴⁵ Applying a banking law statute to the securities context of rating agencies was a novel strategy that bypassed traditional barriers to suing rating agencies.¹⁴⁶ The inherent ambiguity of ratings would have made it difficult for prosecutors to show that S&P’s management knowingly committed fraud.¹⁴⁷ But the threat of billions in sanctions was enough to send S&P to the settlement table and resulted in a landmark award. But although the \$1.37 billion settlement has a deterrent effect against egregious misconduct, S&P admitted no wrongdoing and survived the reputational fallout with its lucrative business model intact.¹⁴⁸ As importantly, the lawsuit has sent a clear message to the leading rating agencies that the federal government will seek to keep rating agencies in check.¹⁴⁹ Nonetheless, the United States government has not taken further concrete steps to roll back the influence of rating agencies, and the SEC backed off from implementing the Franken Amendment.¹⁵⁰

144. See Timothy W. Martin, *S&P Nears \$1.37 Billion Settlement of Crisis-Era Suits*, WALL ST. J. (Jan. 28, 2015, 7:27 PM), <http://www.wsj.com/articles/s-p-justice-department-states-close-to-1-37-billion-settlement-1422460397>.

145. See Lazo & Tangel, *supra* note 5 (discussing the potential implications of the lawsuit against S&P); Aruna Viswanatha & Jonathan Stempel, *S&P Expects U.S. Lawsuit Over Pre-Crisis Credit Ratings*, REUTERS (Feb. 4, 2013, 6:09 PM), <http://www.reuters.com/article/2013/02/04/us-mcgrawhill-sandp-civilcharges-idUSBREg130U120130204> (discussing how the lawsuit against S&P is the first-enforcement action against a rating agency for its role in the financial crisis).

146. See Jean Eaglesham, Jeanette Neumann & Evan Perez, *U.S. Sues S&P Over Ratings*, WALL ST. J. (Feb. 5, 2013, 12:37 AM), <http://www.wsj.com/articles/SB10001424127887324445904578284064003795142> (discussing how the legal strategy makes an “end-run” around traditional barriers to lawsuits).

147. See Jeffrey Manns, *Break Up the Ratings Oligopoly!*, BLOOMBERG (Feb. 18, 2013, 5:30 PM), <http://www.bloomberg.com/news/articles/2013-02-18/let-s-downgrade-s-p-moody-s-ratings-oligopoly>.

148. See Matthew Robinson & David McLaughlin, *S&P Ends Legal Woes: Paying \$1.5 Billion Fine to U.S. States*, BLOOMBERG (Feb. 3, 2015, 7:25 AM), available at <http://www.bloomberg.com/news/articles/2015-02-03/s-p-ends-legal-woes-with-1-5-billion-penalty-with-u-s-states>.

149. For example, Moody’s may also be the target of a FIRREA action as DOJ and the SEC have ongoing probes concerning Moody’s role in the financial crisis. See Jeannette Neumann, *Two Firms, One Trail in Probes of Ratings*, WALL ST. J. (Feb. 10, 2013, 6:58 PM), <http://www.wsj.com/articles/SB10001424127887323511804578296293058057484>.

150. More recently, Fitch reminded the federal government of the power of rating agencies by threatening to downgrade the federal government in response to the October 2013 government shutdown and debt-ceiling stalemate. This pressure helped to foster a debt-ceiling compromise and the reopening of the government, yet left unclear the future of both government and rating-agency accountability in the United States. See *Fitch Places United States’ ‘AAA’ on Rating Watch Negative*, REUTERS (Oct. 15, 2013, 4:44 PM), <http://www.reuters.com/article/2013/10/15/fitch-places-united-states-aaa-on-rating-idUSFit67327220131015>.

In contrast, the tit-for-tat between rating agencies and the European Union was more vitriolic in part because repeated sovereign downgrades exposed the weakness of the Eurozone and cast doubt on the viability of this feature of European integration.¹⁵¹ The sovereign-rating dominos fell in waves as fiscally weaker members of the Eurozone were downgraded from 2008 on, which led to a series of escalating financial guarantees by other Eurozone members that in turn led to further downgrades.¹⁵² The outrage of Eurozone leaders was only equaled by their hypocrisy in seeking to find fault with the leading rating agencies for highlighting the fiscal vulnerability of Eurozone members.¹⁵³

Eurozone regulatory leaders sought to “tame” rating agencies by calling for the suspension of sovereign ratings “in exceptional circumstances,” creating a substitute European Union rating agency, requiring regulators’ pre-approval of rating-agency methods, marginalizing the leading rating agencies by mandating issuers rotate rating agencies and employ smaller competitors, and exposing rating agencies to gross negligence liability.¹⁵⁴ With the notable exception of the call for gross negligence liability, these ideas underscored the European Union’s weakness and appeared designed to attempt to paper over problems or to make rating agencies bend to the European Union’s will and to inflate sovereign ratings.

The idea of banning sovereign ratings faltered because suppressing sovereign ratings not only would blatantly contradict the European Union’s commitment to free speech, but also would ironically serve as a red flag in underscoring the severity of member states’ fiscal problems. For that reason, exercising a ban on sovereign ratings (ostensibly on “prevention of disorder” grounds) would be far more significant than a ratings downgrade in provoking market panic at a potential cover up.¹⁵⁵ The logic behind

151. See, e.g., *The Credit Rating Controversy*, COUNCIL FOREIGN REL. (Feb. 19, 2015), <http://www.cfr.org/financial-crises/credit-rating-controversy/p22328> (discussing how European leaders blamed rating agencies for exacerbating the Eurozone debt crisis).

152. For example, in the wake of the financial crisis small Eurozone countries such as Portugal, Greece, and Cyprus were reduced to non-investment grade status by S&P’s. Bailouts that sought to bolster these states and their banking sectors resulted in further downgrades for many of the stronger Eurozone countries. See *Standard & Poor’s Takes Various Rating Actions on 16 Eurozone Sovereign Governments*, STANDARD & POOR’S (Jan. 13, 2012, 4:36 PM), <http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245327294763>.

153. See, e.g., Peter Wise, *Portugal Condemns ‘Inconsistent’ S&P Downgrade*, FIN. TIMES (Jan. 15, 2012, 5:35 PM), <http://www.ft.com/intl/cms/s/o/047ca726-3f8f-11e1-ad6a-00144feab49a.html#axzz3TCS4nFww> (noting Portugal’s criticism of S&P’s decision to treat Portugal’s debt as non-investment grade as being “ill-founded” and “seriously inconsistent”).

154. See Alex Barker, *Brussels to Unveil Curbs on Rating Agencies*, FIN. TIMES (Nov. 14, 2011, 7:13 PM), <http://www.ft.com/intl/cms/s/o/44075da2-0edc-11e1-b585-00144feabdco.html#axzz3TCS4nFww> (discussing E.U. Internal Market Commissioner Barnier’s controversial proposals to overhaul the rating-agency industry).

155. See Alex Barker, *Barnier Backtracks on Ratings Reforms*, FIN. TIMES (Nov. 15, 2011, 7:38 PM), <http://www.ft.com/intl/cms/s/o/da11c76c-ofb1-11e1-a468-00144feabdco.html#axzz3T>

politicians' calls for a European Union-controlled or funded rating agency was that the leading rating agencies are so entrenched that the only way to foster viable competition is to create one out of whole cloth.¹⁵⁶ A government-owned or funded rating agency would be independent from issuers, but the "solution" would simply replace one conflict of interest with another, more blatant conflict of interest. This idea faltered because of a recognition that markets would likely not trust ratings issued by a government-linked entity for fear that it would inflate the ratings of both sovereigns and companies who enjoy the government's favor.¹⁵⁷ Similarly, calls for regulators to pre-approve rating-agency methodologies were abandoned swiftly because of concerns that regulators would abuse this power to undercut the independence of rating agencies.

The idea to rotate issuers sought to erode the dominance of the leading rating agencies, yet suffered from practical shortcomings.¹⁵⁸ Mandating that issuers rotate rating agencies in three to six-year intervals sought to foster greater competition and open up opportunities for smaller rating agencies and new entrants.¹⁵⁹ The problem with this approach is that small rating agencies are ill equipped to fill this role as the three leading rating agencies account for 96% of the market.¹⁶⁰ As importantly, a rotational approach would not necessarily do anything to create incentives for rating-agency accuracy. In the name of fostering the growth of smaller rating agencies, it could potentially amount to an entitlement system. In the face of a business and rating-agency backlash, European leaders backed down and instead enacted a watered-down pilot program for the rotation of rating agencies every four years for re-securitizations (which is a small fraction of the structured finance market).¹⁶¹

CS4nFww (discussing E.U. Commissioner Barnier's swift retreat on a temporary ban on sovereign ratings in the face of an immediate backlash).

156. See Joseph A. Grundfest & Evgeniya E. Hochenberg, *Investor Owned and Controlled Rating Agencies: A Summary Introduction* 5–6 (Rock Ctr. for Corp. Governance, Working Paper Series No. 66 & Stanford Univ. Law Sch. Law & Econ. Olin, Working Paper Series No. 391, 2009), available at <http://www.ssrn.com/abstract=1494527>.

157. See *Dearth of Investors: Plan to Set Up European Rating Agency Under Threat*, SPIEGEL ONLINE (Apr. 16, 2012, 5:42 PM), <http://www.spiegel.de/international/europe/plan-to-set-up-european-rating-agency-is-failing-according-to-newspaper-a-827876.html>.

158. See Alex Barker, *Move to Curb Rating Agencies Prompts Backlash*, FIN. TIMES (Mar. 29, 2012, 8:19 PM), <http://www.ft.com/intl/cms/s/o/147588d4-79b2-11e1-9900-00144feab49a.html#a3zz3TCS4nFww> (discussing the broad-based resistance to the European Union's rotation proposal).

159. See Jim Brunsten, *Credit Rating Firms in EU to Face Sovereign-Debt Limits*, BLOOMBERG (Nov. 28, 2012, 7:57 AM), <http://www.bloomberg.com/news/2012-11-27/credit-rating-companies-to-face-sovereign-debt-curbs-in-eu-plan.html>.

160. See SEC. & EXCH. COMM'N, 2012 SUMMARY REPORT OF COMMISSION STAFF'S EXAMINATIONS OF EACH NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION 7 (2012), available at <https://www.sec.gov/news/studies/2012/nrsro-summary-report-2012.pdf>.

161. See CRA Regulation III, *supra* note 108, art. 14–18.

European leaders did implement timing and notice requirements for sovereign ratings and prohibited rating agencies from unveiling policy recommendations with sovereign rating watches or updates. Mandating one-day notice before sovereign rating changes may help to avoid errors, and requiring inclusion of a full research report justifying changes is valuable. But limiting sovereign ratings changes to three set times a year and barring “direct or explicit requirements or recommendations from credit rating agencies” merely seeks to postpone and cover up the European Union’s fiscal weaknesses and will have little impact in dampening rating agencies’ influence.¹⁶²

Lastly, the European Union recently expanded opportunities for private oversight of rating agencies to allow private actors to take advantage of greater transparency.¹⁶³ Rating agencies now are exposed to private liability for intentional or grossly negligent infringement of the European Union’s rating regulations, which strike a balance between liability exposure and limits on frivolous litigation.¹⁶⁴ This approach may deter rating agencies from emulating the worst excesses in the run up to the financial crisis. But by definition an extraordinary deviation from ordinary care means that the European Union’s gross negligence will do little to hold rating agencies accountable in the overwhelming majority of cases. Part of the problem is that the cause of action is based on non-compliance with European Union regulations as this liability rule does not address rating agencies’ deeper problems caused by the absence of competition and standards for defining rating accuracy.¹⁶⁵ While incentives for due diligence are positive, in the overwhelming majority of cases rating agencies would face no accountability for the timeliness and accuracy of ratings.

These bold ideas largely fell to the wayside as rating agencies successfully fought most of these reforms behind the scenes and continued to highlight their relevance and impact by announcing changes in their risk assessments of European Union countries.¹⁶⁶ While European Union politicians were more vocal and potentially radical than their American counterparts, reforms on both sides of the Atlantic largely converged into watered-down measures

162. See *id.* arts. 42, 45.

163. See *id.* arts. 5a, 35a.

164. See *id.* art. 35a; Manns, *supra* note 34, at 1076–84 (proposing a gross-negligence standard for rating-agency liability similar to what the European Union embraced).

165. Cf. Mark Fenster, *The Opacity of Transparency*, 91 IOWA L. REV. 885, 902–10 (2006) (discussing the limits of transparency).

166. See, e.g., David Jolly, *S.&P. Cuts European Union’s Credit Rating*, N.Y. TIMES (Dec. 20, 2013), <http://www.nytimes.com/2013/12/21/business/international/sp-cuts-european-unions-credit-rating.html> (discussing S&P’s decision to downgrade the European Union’s credit rating to one notch below AAA based on the weaker creditworthiness of the 28 member states); *European Sovereign Ratings and Related Materials*, STANDARD & POOR’S, <http://www.standardandpoors.com/ratings/sovereign-actions/en/us> (last visited Mar. 23, 2015) (detailing S&P’s sovereign rating changes for European Union countries).

that left the most important issues of rating-agency competition and accountability unresolved. The irony is that the regulatory reforms that were implemented significantly raised the costs of being a rating agency and erected barriers to entry in the industry, which may reinforce the leading rating agencies' dominance.

American and European reforms failed to resolve the difficult questions of how to foster rating-agency accuracy and constructive competition. Both American and European reforms have embraced the rhetoric of promoting the selection of rating agencies based on performance, but the challenge is determining the benchmark for assessing rating-agency performance. The danger is that performance standards may perversely distort ratings or accentuate herding effects. Similarly, reforms barely touched the question of how to lower barriers to entry for new rating agencies and facilitate competition.

Part of the challenge is that no clear consensus exists on what performance-based standards to use to assess rating agencies.¹⁶⁷ The SEC or ESMA are ill equipped on their own to address these questions, yet there is no framework or organization in place for participants in the security industry to tackle this difficult and essential question. Proposals have suggested creating peer comparison models to examine whether rating agencies' percentage of predicted default of debt instruments deviated from that of their peers and whether annual yields of identically rated debt securities from different asset classes varied in a significant way.¹⁶⁸ The dilemma of either of these performance-based metrics is that they may accentuate herding effects. Rating agencies would have greater incentives to engage in conscious parallelism to avoid liability, which could undercut the objectives of greater accuracy and accountability. Herding effects are already an issue in an oligopolistic industry,¹⁶⁹ and the solution could exacerbate the problem. An additional concern is that the benchmark would swiftly become the centerpiece of rating agencies' methodologies, regardless of whether the standards incentivize accuracy and timeliness.

Another important issue that industry participants need to resolve is gauging the merits of standardizing ratings. In theory, standardizing ratings will help facilitate comparability and creating performance-based tests will foster accountability.¹⁷⁰ But the danger exists that these approaches may

167. See Coffee, *Ratings Reform*, *supra* note 7, at 258 (arguing that “[a] reliable track record for accuracy might take a decade or more to develop”).

168. See Onnig H. Dombalagian, *Regulating Informational Intermediation*, 1 AM. U. BUS. L. REV. 58, 74–75 (2012).

169. See, e.g., Thomas A. Piraino, Jr., *Regulating Oligopoly Conduct Under the Antitrust Laws*, 89 MINN. L. REV. 9, 10–11 (2004) (discussing the pervasiveness of conscious parallelism in oligopolistic industries because the small number of players facilitates coordination without express communication).

170. See, e.g., Bai, *supra* note 82, at 96–97 (advocating the virtues of rating standardization).

undercut rating agencies' incentives to create their own distinctive tests of risk and may leave all market participants worse off by forcing analyses through a single lens and thwarting innovation.¹⁷¹

Lastly, the stakeholders who purchase or rely on ratings for debt-purchase decisions may better appreciate what smaller entrants or new competitors need to do to become credible alternatives to the leading rating agencies. The European Union's pilot rotational program would open up opportunities for small or new rating agencies. But regulators' low bar on who can qualify as a rating agency appears to be inadequate as few issuers or debt purchasers would want to rely on a *reputational* intermediary that meets the current bare-minimum requirements.¹⁷² Instead of foisting smaller rating agencies on debt issuers, regulators would benefit from the development of professional standards for rating agencies by the spectrum of industry stakeholders.¹⁷³

D. THE CASE FOR A RATING-AGENCY STAKEHOLDER REGULATORY ORGANIZATION

Since sovereign ratings raise conflicts of interest that potentially compromise the integrity of both sovereign states and rating agencies, effective regulation requires moving beyond a false dichotomy of relying on either government or self-regulation.¹⁷⁴ The role of rating agencies as monitors of sovereign risk casts a shadow over government regulation due to the reciprocal oversight problem. Government actors have incentives to exert power over rating agencies to dampen the influence of ratings and to deter rating agencies from highlighting sovereign weakness. Additionally, the questions of how to heighten rating-agency accountability and competition have eluded regulators as rating-agency reforms have not addressed these issues in any meaningful way.

The problem is that the reciprocal oversight problem has two dimensions. Just as governments may be suspect in their regulatory roles, private rating agencies may have perverse incentives to leverage sovereign ratings to their advantage. This fact makes self-regulation potentially problematic. Policymakers historically assumed that the reputational concerns of rating agencies would provide strong incentives for their integrity and accuracy, and eclipse any short-term gains from turning a blind eye to

171. See, e.g., WALL STREET REPORT, *supra* note 105, at 17.

172. See, e.g., 15 U.S.C. § 780-7 (2010) (detailing the modest requirements to be a Nationally Recognized Statistical Rating Organization in the United States).

173. See Jody Freeman, *Extending Public Law Norms Through Privatization*, 116 HARV. L. REV. 1285, 1328-29 (2003) (discussing the virtues of industry self-regulation and professional-standard setting).

174. See Sinclair, *supra* note 2, at 531 (discussing how academics and policymakers often falsely present a choice between the extremes of government control and complete self-regulation).

client misconduct.¹⁷⁵ Unfortunately, this assumption proved to be incorrect as reputational constraints waned amidst market-wide increases in risk-seeking behavior.¹⁷⁶

Part of the challenge is that the inherent ambiguity of ratings poses pitfalls for self-regulation and market discipline. Rating agencies can hide behind their own approaches in assessing risk through a bucket system of categories and can use the opaqueness of ratings both to acknowledge the reality of uncertainties and as a cover for inaccuracy. Rating agencies can also elastically spin their failures as a product of the shortsightedness and knee-jerk reactions of markets, because ratings focus on structural, long-term concerns.¹⁷⁷

The question is whether the challenges facing rating-agency accuracy and accountability could be better addressed at a collective level through a self-regulatory organization composed of rating agencies. In theory, a self-regulatory organization approach would be appealing for rating agencies since the leading rating agencies are concentrated in the United States and the European Union, so either the SEC or ESMA (or both) could delegate rating agencies with this task. The complexity of ratings means that rating agencies would be better positioned to recognize and address emerging problems than regulators and have incentives to do so to avoid heavy-handed or misguided regulation.¹⁷⁸ Rating agencies would have incentives to design rules that can be practically implemented and are positioned to monitor one another for compliance.¹⁷⁹

The problem is that the oligopolistic nature of the rating-agency industry and the layers of conflicts of interest that exist make it likely that a pure self-regulatory organization would serve to reinforce the status quo.¹⁸⁰ As noted earlier, rating agencies are generally selected and paid by debt issuers, which incentivizes deferential ratings for paying clients. This fact may give rating agencies incentives to craft rules that legitimize the regulatory tilt in favor of issuers or reinforce the ambiguity of ratings.¹⁸¹ This danger is accentuated by

175. See Coffee, *supra* note 26, at 1406.

176. *Id.* at 1412–13.

177. See MOODY'S INVESTORS SERV., MEASURING THE PERFORMANCE OF CORPORATE BOND RATINGS 7, 15 (2003) (discussing the emphasis on long-term concerns in determining ratings through the process of “fundamental credit analysis”).

178. See Hu, *supra* note 30, at 1463–64 (discussing the limitations of government regulators' ability to oversee complex financial risks).

179. See SCHULZ & HELD, *supra* note 32, at 12–16 (discussing how self-regulation can facilitate more rapid decisionmaking and implementation than government rulemaking); Stefanadis, *supra* note 32, at 5, 6–8 (discussing how self-regulation facilitates the rapid development of industry-wide innovation and standards).

180. See Macey & O'Hara, *supra* note 1, at 565–67 (discussing the tension between the profit focus of the securities industry and incentives for effective self-regulation).

181. See Manns, *supra* note 7, at 757–60 (discussing the entrenchment of the ratings oligopoly and the impact of the issuer-pays conflict of interest).

the fact that 96% of ratings are issued by three leading rating agencies. This means that pure self-regulation could simply be a tool of entrenchment.¹⁸² The leading rating agencies could use a self-regulatory organization as a means of collusion to erect standards that would make it difficult for smaller rating agencies to compete. Rating agencies would have incentives to appear responsive to government demands for transparency, accuracy, and accountability, while crafting rules that do little to further these goals in substance.¹⁸³

The distinctive challenges that a rating-agency self-regulatory organization would face cast doubt on the viability of this self-oversight strategy, but not on the desirability of collective action to enhance rating accuracy and industry accountability. Rating-agency reforms have long languished because of the difficulty of resolving the question of whom rating agencies should be accountable to. Government requirements for a broad range of actors—such as money market funds, banks, and regulators—to refer to ratings for risk assessments effectively made ratings a public good and created widespread reliance that has survived the abolition of these requirements.¹⁸⁴ But rating agencies have repeatedly succumbed to temptations to tilt ratings towards issuers because issuers pay the bills. Additionally, the reciprocal oversight problem means that rating agencies also face pressure to tilt ratings towards developed-world sovereigns, too, because of the threat of regulatory intervention. In contrast, debt purchasers who rely on ratings as proxies of credit risk have no direct role in terms of accountability and oversight.

One answer to this problem is to create greater rating-agency accountability to end users—debt purchasers who rely on ratings as proxies of the risk they are taking on. For example, strengthening private causes of action for debt purchasers by lowering pleading standards for rating-agency fraud or exposing rating agencies to liability for negligence would give debt purchasers greater incentives to monitor ratings.¹⁸⁵ The resulting liability exposure could dampen rating agencies' incentives to tilt ratings in favor of

182. See Andrea Rönberg, *S&P Warning Puts Damper on Eurogroup Plans*, DEUTSCHE WELLE (May 7, 2011), <http://www.dw.de/sp-warning-puts-damper-on-eurogroup-plans/a-15212433-1> (discussing the market share of the leading rating agencies).

183. See John Braithwaite, *Responsive Regulation for Australia*, in BUSINESS REGULATION AND AUSTRALIA'S FUTURE 81, 93 (Peter Grabosky & John Braithwaite eds., 1993), available at http://www.aic.gov.au/media_library/publications/lcj/business/business.pdf (discussing the concern that self-regulation can be a façade designed to build false faith in industry and foster complacency about government inaction).

184. See SEC Concept Release, 68 Fed. Reg. 35,258, 35,259 (June 12, 2003); Gregory Karp, *Ratings Game: Power of S&P, Other Top Credit Agencies, Grew from Government Action*, CHI. TRIB. (Aug. 14, 2011), http://articles.chicagotribune.com/2011-08-11/business/ct-biz-0814-sp-20110814-1_credit-rating-agency-statistical-rating-organizations.

185. Cf. CRA Regulation III, *supra* note 108, at 20–21 (imposing liability for intentional or grossly negligent infringement of the European Union's rating-agency regulations).

issuers or sovereigns. The challenge is that it may be difficult to heighten rating-agency accuracy by pulling rating agencies in multiple directions.¹⁸⁶

Instead of replacing one problem with another, the SEC or ESMA could create a broader system of rating-agency accountability to the spectrum of stakeholders who rely on ratings. Creating a rating-agency *stakeholder regulatory organization* would recognize the desirability of collective action and seek to temper the biases of the current system by giving representatives of debt issuers, debt purchasers, and rating agencies themselves a say in overseeing the rating-agency industry and developing industry standards.¹⁸⁷ The challenge is the degree to which end users would be sufficiently informed about the nature of the ratings process, compared to issuers who have gained this knowledge in routinely gaming the system to secure high ratings. However, end users would have strong incentives to organize collectively and to enlist informed representatives to protect their interests in a stakeholder regulatory organization.¹⁸⁸

Part of the problem facing rating-agency accountability is the lack of any contractual relationship between rating agencies and the debt purchasers who rely on ratings, which makes *ex ante* oversight difficult.¹⁸⁹ Giving debt-purchaser representatives seats at the table of a stakeholder regulatory organization would empower debt purchasers to play a role in advocating greater accuracy and accountability. But the diversity of debt purchaser

186. See, e.g., Brigitte Haar, *Civil Liability of Credit Ratings Agencies After CRA 3—Regulatory All-or-Nothing Approaches Between Immunity and Over-Deterrence* (Univ. of Oslo Faculty of Law Legal Studies, Research Paper No. 2013-02, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2198293 (raising the danger that investors will try to leverage a lower pleading standard to seek compensation for their primary investment loss, regardless of rating agencies' culpability).

187. The academic debate on self-regulatory organizations has focused on the degree of government control versus the degree of industry control. See, e.g., Black, *supra* note 44, at 115–18 (discussing the spectrum of degrees of government and industry self-regulation); Gunningham & Rees, *supra* note 44, at 391–92 (discussing the continuum of industry self-regulation from voluntary self-regulation to mandated partial self-regulation and full government control); Omarova, *supra* note 2, at 438–39 (advocating embedded self-regulation consisting of an integration of government regulation and self-regulation). But no one has raised the idea of a “stakeholder regulatory organization” that incorporates the spectrum of stakeholders into industry regulation.

188. While securities self-regulatory organizations frequently have an adjudicative role to resolve claims against its members, the focus of this Article is on the potential role a stakeholder regulatory organization could play in developing industry standards and engaging in rule-making. The conflicting interests of a spectrum of stakeholders may make it more difficult for the organization to adjudicate claims between different factions of the stakeholder regulatory organization's membership. See Birdthistle & Henderson, *supra* note 1, at 62–64 (discussing the adjudicative role of U.S. self-regulatory organization FINRA).

189. *Ex post* accountability was recently introduced in the European Union for issuer or debt-purchaser damages caused by intentional or grossly negligence violations of the CRA Regulation I and amendments (although gross negligence will still be a high bar for a successful suit). See CRA Regulation III, *supra* note 108, art. 35a. But compliance with the E.U. ratings regulations is not tantamount to *ex ante* incentives for timely and accurate ratings.

interests would make it difficult to determine which group of debt purchasers should serve as representatives. Similarly, there are challenges in determining which debt issuers should have a say in the regulatory process, since there is a spectrum of issuers with varying stakes in rating accuracy and timeliness.

Any of the three approaches for selecting stakeholders that were discussed earlier could potentially be used to address the challenge of determining which issuers and debt purchasers would best represent the range of stakeholders.¹⁹⁰ The simplest approach would be to identify the debt issuers and end purchasers with the largest financial stakes over a multi-year time horizon and then to consider the typicality and adequacy of these stakeholders. The information on financial stakes is publicly available and would yield lists of well-known seasoned issuers on the corporate side, large debt sovereign debt issuers, such as the United States and Japan, and high-profile institutional investors, such as Vanguard, Fidelity, and T. Rowe Price. A similar analysis of rating agencies with the largest financial stakes would yield the big three—S&P, Moody's, and Fitch—who account for the overwhelming majority of ratings.¹⁹¹

The key question would be the typicality and adequacy of these stakeholders.¹⁹² There are a variety of different ways to think about this question. One way would be to analyze the typicality and adequacy of these stakeholders for different classes of debt, such as sovereign, corporate, financial, or insurance debt.¹⁹³ The overlap between rating agencies and end purchasers would be remarkably consistent as the same three rating agencies and many of the same leading institutional investors would be the leading players in each context. In that sense, the same set of institutional investors would appear to be adequate representatives to different categories of end purchasers because of the breadth and scale of their financial interests.

One question would be whether institutional investors' interests are typical of other end purchasers of the range of debt categories. For example, one concern would be that institutional investors are likely repeat players with debt issuers and therefore are potentially conflicted. This point would be particularly true for institutional investors who may have cozy relationships with investment banks who give them preferred access to initial public offerings and debt issuances and then these institutional investors in turn flip those investments on to secondary markets.¹⁹⁴ For that reason it may make sense to break down debt purchasers based off of not only categories of debt,

190. See *infra* Part II.C.

191. See SEC. & EXCH. COMM'N, *supra* note 160, at 7.

192. See, e.g., Webber, *supra* note 50, at 160; Weiss & Beckerman, *supra* note 50, at 2126.

193. See SEC. & EXCH. COMM'N, *supra* note 160, at 6 (detailing the breakdown of the different sectors of the ratings market).

194. See, e.g., Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 546–48 (1997) (discussing a range of conflicts of interest that institutional investors face that may make them not representative of other types of investors).

but also based on whether they focus on primary or secondary market purchases since their interests may diverge. For example, primary sovereign-debt purchasers may rely on ratings to ensure that they are buying a marketable product, but routinely sell out their stakes to secondary markets in rapid fashion, so they will care less about the timeliness and accuracy of subsequent ratings changes. In contrast, secondary-market purchasers are more likely to buy and hold debt issuances and therefore the largest debt holders may have a stronger interest in the accuracy and timeliness of rating changes.

But even institutional investors like Vanguard who tend to buy and hold debt (based on their focus on index funds) may not be typical of end users because they are more likely to embrace a passive approach towards regulatory issues.¹⁹⁵ Institutional investors may not want to push for greater regulation of rating agencies for fear that there would be a backlash among their debt issuer and investment bank counterparts who do not want to deal with more stringent rating regulation, which could affect the degree of access institutional investors have to primary market debt issuances. Or these actors may be so sophisticated that they take ratings with a grain of salt and recognize the limitations of ratings as proxies of creditworthiness. Instead, large institutional investors may be more likely to rely on their own internal analysts to assess credit risks to give them an informational advantage over the broader market.¹⁹⁶

For that reason it may make sense to recognize that scale matters in terms of the degree of reliance on ratings and the resulting interest in heightening the accuracy and timeliness of ratings. That would justify including as a separate category potential stakeholders who represent mid-size or smaller institutional investors whose interests are more likely to correspond with that of the broader end user market, but who would still potentially have the economic wherewithal to be adequate representatives of the class of investors (unlike individual retail investors).

A similar principle could be applied to ensure broad-based representation of debt issuers. For example, stakeholder representation should include not only well-known seasoned issuers, but also representation of non-reporting and unseasoned issuers who would have divergent interests because are they new to the debt-issuance process or have low levels of outstanding debt.¹⁹⁷ Ratings would matter far more to non-reporting and

195. See, e.g., *Index Funds Could Help Lower Long-Term Costs*, VANGUARD, <https://investor.vanguard.com/mutual-funds/index-funds> (last visited Mar. 24, 2015).

196. See Claire A. Hill, *Rating Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV. 1145, 1154 & n.65 (2003) (discussing how institutional investors typically have in-house analysts to assess the value of bonds).

197. See Donald C. Langevoort & Robert B. Thompson, “Publicness” in *Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 379 & n.179 (2013) (discussing the distinguishing features of well-known seasoned issuers).

unseasoned issuers since markets would be less familiar with these companies and therefore would be more likely to rely on ratings as proxies for their risk exposure.¹⁹⁸ Interested issuers with the largest issuances in the categories of well-known seasoned issuers and non-reporting and unseasoned issuers could serve as representatives of issuer perspectives on ratings.

Lastly, similar justifications of size would apply to ensure that the spectrum of rating agencies would be represented in a rating-agency stakeholder regulatory organization. As discussed earlier, the leading rating agencies would have every incentive to design rating-agency regulation in ways that create barriers to entry for new entrants or smaller rating agencies in order to entrench their oligopolistic dominance. The small and fledgling rating agencies are likely to have distinctive interests in heightening competition for ratings and pursuing regulatory measures that would open up the market and would need to have their interests represented. One of the biggest challenges in a rating-agency stakeholder regulatory organization would be bridging this chasm of interests which significantly diverge.

A related question would be how to weigh the respective interests of different stakeholders. The leading rating agencies in particular would want to have de facto veto power in being able to block reforms or ensure reforms have their imprimatur. The challenge of embracing the first approach of selecting individual representatives is that controversies would arise concerning how to determine how many different types of representatives would play a decision-making role and the degree of super-majority support needed for decision-making. Policymakers would need to establish a framework for representation that would not be skewed in favor of debt issuers, end purchasers, or rating agencies. The super-majority threshold for decision-making would need to be set high enough to ensure that a broad cross-section of debt issuers, end users, and rating agencies agree on the contours of a proposed reform. The SEC or ESMA could still trump the stakeholder regulatory organizations' decisions by exercising their regulatory powers.¹⁹⁹ But achieving a high degree of consensus within the stakeholder regulatory organizations would carry significant weight and legitimacy—which would make it hard for regulators to dismiss their recommendations.²⁰⁰

The question of how to weigh representation is a dimension of the puzzle in which a stakeholder committee approach may have some advantages in providing a framework for enlisting multiple actors for each category of stakeholder. A stakeholder committee approach would have to be concerned both with the internal composition of the committees and the degree of super-majority support among committees that would be needed to reach

198. See Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,731 (Aug. 3, 2005) (laying out the definitions for non-reporting and unseasoned issuers).

199. See *supra* note 62.

200. See *supra* note 63.

decisions. But it would provide a greater outlet for dialogue among potentially divergent interests within a category of stakeholders, such as among rating agencies or among well-known seasoned issuers. Creating contexts for categories of stakeholders to forge consensus may yield benefits by highlighting the degree of common ground that does exist. The challenge with the stakeholder committee approach is that it would be difficult to mobilize large numbers of issuers and end purchasers to be involved. For the stakeholder committee approach to work, there would need to be an impetus for broad-based involvement and action, such as credible threats for government action in the wake of a future economic crisis. Policymakers would need to consider whether the cost and greater complexity of a stakeholder committee approach would be worth the benefits of broader-based involvement.

A third approach would be to rely on trade associations, industry groups, and shareholder advocacy organizations to represent the range of stakeholders.²⁰¹ Either the SEC or ESMA or an independent board could award representation to trade associations or industry groups that best reflect the spectrum of debt issuer and end purchaser interests. Trade associations are the primary actors lobbying legislators and regulators behind the scenes to further the interests of issuers and debt purchasers in ratings reforms, so the virtue of this approach is that these groups would not have to be created out of whole cloth.²⁰² One concern is whether the years of bitter clashes over the implementation of rating-agency reform would spill over into a stakeholder regulatory organization and make consensus even more difficult to achieve. The related concern is that industry groups may represent interests of institutional investors far better than that of retail investors because shareholder advocacy groups have been traditionally weak due to the collective action problems that complicate their very existence.²⁰³ Enlisting trade associations and industry groups as stakeholder representatives may simplify the process of identifying plausible representatives. But the tradeoff that policymakers would have to consider is the degree of risk that industry lobbyists would potentially swamp other stakeholder voices and distort decision-making processes. While a spectrum of stakeholders would be better positioned than government officials to address some of the longstanding problems facing the rating-agency industry, this approach would only be the first step of working through numerous stumbling blocks to successful reform of the industry.

201. See, e.g., Freeman, *supra* note 52, at 33–36 (discussing the potential for an expanded interest-group role in agency decisionmaking).

202. See *supra* note 69.

203. Cf. Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 271 (2003) (discussing how investors are poorly positioned to engage in effective collective action).

The danger is that self-interest could potentially place debt issuers and purchasers into entrenched, sharply conflicting positions. Debt issuers may prefer the status quo of inflated ratings, while debt purchasers may advocate systematically conservative assessments of risk. The leading rating agencies would have strong incentives to appear responsive to pressures for reform, while seeking to stymie the process in practice. For this reason, achieving a high degree of consensus among these divergent interests would be difficult. This challenge would be magnified by the fact that during economic expansions both the government and the full range of stakeholders would have little interest in addressing rating-agency reform because prosperity would mask the degree of problems.

The prospects for success would be greatest in the wake of a future economic crisis. Popular backlashes to financial market failure would spur legislators and regulators to threaten potential action. However divided stakeholders may be, they may be much more likely to reach consensus to avoid ill-informed government action. For example, both the SEC and ESMA possess powerful regulatory tools to incentivize consensus among private parties. Either agencies, or both in tandem, could pressure parties to reach agreement on regulatory priorities or face the threat of unilateral government action which would heighten uncertainty and risk for all concerned. Regulators could also employ a regulatory default approach in which they identify potential default rules to set a stakeholder regulatory organization's agenda and spur stakeholders to act.²⁰⁴ For example, the SEC could enact a default recklessness liability rule on rating agencies that would come into effect if industry participants could not agree on a liability standard.²⁰⁵ Rating agencies would plausibly respond by threatening to withhold ratings for high-risk segments of the debt market and to raise the price of ratings to reflect this dramatic expansion of risk exposure. These changes would hurt debt markets in ways that would affect both issuers and debt purchasers and could pressure stakeholders to reach consensus on a less disruptive standard of liability or other regulatory solution.

The downside of this approach is that stakeholders who stand to gain (or lose less) from the proposed default rule would have incentives to work to undermine compromises without blatantly opposing the process. For example, well-known seasoned issuers, established companies with at least \$700 million of equity or \$1 billion in debt outstanding,²⁰⁶ may believe they

204. The regulatory default concept has been used in the environmental-law context to provide regulated parties with incentives to produce new information and make the case for alternatives. *See, e.g.,* Karkkainen, *supra* note 9, at 869–70.

205. The SEC has twice considered and backed away from expert liability because of rating-agency resistance. *See* Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933, 74 Fed. Reg. 53,114, 53,114–15 (Oct. 15, 2009); Morgenson, *supra* note 133 (describing the SEC's capitulation to rating-agency resistance to expert liability).

206. *See supra* note 197.

stand to gain market share if a recklessness standard makes ratings less widely available and regard that as well-worth paying a higher price for ratings. This fact may make decisions about both the weighting of representation and super-majority decision-making crucial in ensuring that holdouts do not frustrate the underlying purpose of the stakeholder regulatory organization. But it also raises the necessary caveat that there are limits to how much external pressure may foster consensus among stakeholders. The fallout from a financial crisis will create the most favorable circumstances for reaching agreement among stakeholders to preempt government action, but it will not necessarily bridge the deep fault lines of interest that exist. It is important to recognize that a stakeholder regulatory organization may mitigate some of the shortcomings of government and self-regulation, but divisions and conflicts over the direction of reform will still pose significant stumbling blocks.

Another important caveat is the need to acknowledge the limitations of a rating-agency stakeholder organization to put the potential of this approach in the proper light. As discussed earlier, some of the problems facing rating-agency regulation do not have an easy or clear solution, even if consensus were readily possible. Some issues such as the standardization of ratings may be easier to achieve consensus on than on establishing uniform benchmarks for assessing the timeliness and accuracy of ratings because of the intrinsic challenges in making these determinations. Other issues may simply be intractable such as the issuer-pays system. The unity of interest between debt issuers and rating agencies may be too hard to overcome since both benefit from this symbiotic relationship. Even if this conflict of interest becomes a focal point of reform in the wake of another financial crisis, there may still be fierce resistance because it would strike at the core of the industry. For that reason it would be important to have realistic expectations for a rating-agency stakeholder regulatory organization as it could be an important part of rating-agency reform. But this approach alone wouldn't address all of the significant stumbling blocks facing reform in the rating agency or broader financial contexts.

IV. CONCLUSION

The clashes between Western countries and the leading rating agencies and the shortcomings of reforms underscored the significance of the reciprocal oversight problem. This inherent conflict of interest is a widespread problem as both government and industry actors have leveraged their oversight roles to obscure risk taking and minimize accountability. The irony is that mutual oversight has become in practice mutual empowerment to engage in reckless leverage and risk taking during booms and sidestep meaningful accountability and reforms during busts.

Instead of relying on government or self-regulation, American and European policymakers should consider creating stakeholder regulatory organizations that integrate a spectrum of stakeholders into private regulatory

organizations. The logic is that integrating end users of financial services into deliberative processes will mitigate industry biases and produce rules that preempt the need for government regulation. This approach would be designed to temper abuses of self-regulation, while mitigating the risk that government regulation of the financial sector will be used as a means to deter government accountability. The standard for success may not necessarily be the efficacy of a stakeholder regulatory organization during times of economic booms as both stakeholders and regulators may be blinded by the haze of prosperity. But having a stakeholder regulatory organization in place may bear the most dividends when it comes time to craft credible responses to the next crisis as both rating-agency stakeholders and regulators will face greater incentives for action. While significant challenges would remain for financial reforms, this framework could provide a path forward that mitigates the impact of the reciprocal oversight problem on financial regulation.