Credit Rating Agencies and the Financial CHOICE Act

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In this essay, we analyze the role of credit rating agencies (CRAs) in the financial crisis of 2007-2009, the subsequent regulatory changes enacted as part of Dodd-Frank in 2010, and the proposals that make up the CHOICE Act. Dodd-Frank tried to address two major issues—the conflict of interest that is inherent in the "issuer-pays" model and the regulatory reliance on ratings—prescribing new rules for internal control and governance, independence, transparency, and liability standards. These provisions are quite onerous in terms of compliance, while appearing to yield only modest benefits. However, regulatory reliance on ratings has since been substantially (and sensibly) reduced.

Regarding credit ratings and ratings agencies, the Financial CHOICE Act changes the Dodd-Frank Act in two ways: (i) the SEC has exemptive authority for the Dodd-Frank Act's provisions if a provision creates a barrier to entry into the market for a potential nationally recognized statistical rating organization (NRSRO); and (ii) the CHOICE Act repeals the Franken Amendment, but offers no alternative in its place.

We argue that, even without official regulatory reliance, credit ratings still play an important role in the regulatory framework. Increasing competition can lead to a race to the bottom. Therefore, it is crucial that the regulation of ratings agencies addresses the conflict of interest within the issuer-pays model. The CHOICE Act drafters should be more forthright in acknowledging the dangers of the issuer-pays model, and in encouraging the SEC to be more creative in considering alternatives. Further, we urge the CHOICE Act drafters to consider abolishing the NRSRO category itself, so as to lower the barriers to entry into the rating agency business generally.