

RATED P FOR PUBLIC: LEARNING FROM DODD-FRANK AND CREDIT RATING AGENCIES TO PROPOSE A PUBLIC CRYPTOCURRENCY RATING PROVIDER IN THE UNITED STATES

Parth Kalaria*

Credit rating agencies have long played an important role in the economy of the United States. In response to the financial crisis of 2008, the Dodd-Frank Wall Street Reform and Consumer Protection Act introduced reforms to increase the transparency and accountability of credit rating agencies. With the rise of cryptocurrencies and the expansion of blockchain technology, established credit rating agencies are now considering offering ratings for cryptocurrencies, in the same way they rate traditional securities.

Borrowing from the lessons learned from the experience of the 2008 financial crisis, this Note proposes that the United States government create a public agency to provide cryptocurrency ratings. The Note begins by providing background information on cryptocurrencies, blockchain technology, credit rating agencies, and the subprime mortgage crisis of 2008. Next, it discusses problems in the credit rating process that were not solved by Dodd-Frank—namely, the prevalence of fraud and conflicts of interest between rating agencies and issuers. The Note then proposes the public cryptocurrency rating agency solution and additional supplementary reforms that may be adopted to address these

* J.D. Candidate 2021, Columbia Law School; B.B.A. 2018, The University of Texas at Austin. I would like to thank Columbia Law School Professor Joshua Mitts and *Columbia Business Law Review* 2019–2020 Editorial Board Members Katy Berk, Jingxi Zhai, and Mackenzie Humble for their invaluable assistance and comments throughout the drafting process.

unsolved problems.

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I. INTRODUCTION

The notion of cryptocurrency (“crypto”) becoming mainstream in the United States would likely have once drawn skepticism from most individuals. Yet as we observe the rise of cryptocurrency and blockchain technology around the world, the possibility of cryptocurrency’s mainstream status and widespread use has become more accepted. The Cryptocurrency Act of 2020 provides evidence of cryptocurrency’s mainstream potential, as U.S. lawmakers begin to concern themselves with the regulation of digital assets.¹ Additionally, an increasing number of vendors have begun to accept cryptocurrency as a valid form of payment,² and some companies have even started to assign ratings to cryptocurrencies.³ This rating process attempts to determine what the “best” cryptocurrencies are.⁴ One approach to rating cryptocurrency involves looking at specific factors to evaluate each token, such as their underlying technology, likelihood of adoption, associated risk, and potential future reward.⁵

Common wisdom used to hold that secondary markets for cryptocurrency fundamentally differed from traditional capital markets. Indeed, one commentator noted that “[t]he traditional market-based antidotes—signaling, underwriter reputation, and accountant or credit-rating certification—simply

¹ See Cryptocurrency Act of 2020, H.R. 6154, 116th Cong. (2020). See also Jason Brett, *Congress Considers Federal Crypto Regulators in New Cryptocurrency Act of 2020*, FORBES (Dec. 19, 2019), <https://www.forbes.com/sites/jasonbrett/2019/12/19/congress-considers-federal-crypto-regulators-in-new-cryptocurrency-act-of-2020/#1817bfd25fed> [https://perma.cc/B2F5-45FF].

² Anthony Cuthbertson, *Bitcoin Now Accepted at Starbucks, Whole Foods and Dozens of Other Major Retailers*, INDEP. (May 14, 2019), <https://www.independent.co.uk/life-style/gadgets-and-tech/news/bitcoin-stores-spend-where-starbucks-whole-foods-crypto-a8913366.html> [https://perma.cc/FVU7-Q5D9].

³ David Canellis, *Weiss Ratings: EOS is the Best Cryptocurrency, Then Ripple, and THEN Bitcoin*, TNW (Mar. 26, 2019), <https://thenextweb.com/hardfork/2019/03/26/weiss-ratings-cryptocurrency-eos-ripple-bitcoin/> [https://perma.cc/U69M-SF78].

⁴ *Id.*

⁵ *Id.*

do not apply [to cryptocurrency markets] as there are no underwriters, analysts, credit rating agencies, or accountants in the crypto context.”⁶ This thought has slowly been disproven as established credit rating agencies have begun to enter the cryptocurrency rating space.⁷

The changing times offer a ripe opportunity to analyze cryptocurrencies in a similar manner to how one might analyze securities traditionally rated by credit rating agencies. Much of the criticism surrounding cryptocurrency stems from the extreme volatility in many cryptocurrencies’ value.⁸ This volatility makes it difficult to analogize between cryptocurrencies and more stable financial instruments that are commonly rated by credit rating agencies. Nevertheless, one theory posits:

[I]t is possible that through ubiquity and standardization, the volatility of a virtual currency might be sufficiently moderated such that it comes to be seen as a sufficiently reliable store of value that can serve as collateral for repo transactions—the same unit of virtual currency can then be re-pledged (potentially *ad infinitum*), and in this way, become a systemically important means of exchange amongst financial institutions.⁹

The possibility that cryptocurrencies will become more commonplace lends credence to the importance of cryptocurrency ratings.

⁶ Shlomit Azgad-Tromer, *Crypto Securities: On the Risks of Investments in Blockchain-Based Assets and the Dilemmas of Securities Regulation*, 68 AM. U. L. REV. 69, 85 (2018).

⁷ Michael del Castillo, *Morningstar is Building a Blockchain Bridge to the \$117 Trillion Debt Securities Industry*, FORBES (Oct. 1, 2019), <https://www.forbes.com/sites/michaeldelcastillo/2019/10/01/morningstar-is-building-a-blockchain-bridge-to-the-117-trillion-debt-securities-industry/#64ef05853612> [<https://perma.cc/V4TN-68DS>].

⁸ Aatif Sulleyman, *Bitcoin Latest: Cryptocurrency is Too Volatile to be Used as Money, Experts in Davos Warn*, INDEP. (Jan. 26, 2018), <https://www.independent.co.uk/life-style/gadgets-and-tech/news/bitcoin-latest-price-too-volatile-money-currency-davos-2018-world-economic-forum-invest-a8179541.html> [<https://perma.cc/5DQQ-ZJZJ>].

⁹ Hilary J. Allen, *Bitcoin?*, 76 MD. L. REV. 877, 919 (2017).

The relevance of cryptocurrency ratings may increase in the coming years, given that a reputable credit rating agency, Morningstar, recently announced that it will soon enter into the cryptocurrency rating space.¹⁰ As additional credit rating agencies follow Morningstar's path, it is important to consider how lessons learned from credit rating agencies can be applied to cryptocurrency rating agencies. Drawing upon such lessons—in particular from the credit rating agency reforms put into place by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)¹¹—this Note proposes that the U.S. government should create a public agency to provide cryptocurrency ratings.

As the use of cryptocurrencies becomes more prominent in the global economy, investors will need an accurate representation of each cryptocurrency's value. A rating can be both useful and dangerous because individuals rely on it as an indicator of a cryptocurrency's value and legitimacy. Inaccurate signaling of a cryptocurrency's worth may lead to significant problems, such as an investment bubble or market manipulation.¹²

This Note proceeds in six Parts. Part II offers relevant background information on cryptocurrency, blockchain technology, credit rating agencies, the subprime mortgage crisis and rating agencies' involvement, and the portions of Dodd-Frank relevant to credit rating agency reform. Given cryptocurrency's increasingly mainstream status, it is useful to analogize between credit rating agencies and cryptocurrency rating providers, especially as established credit rating agencies begin to provide ratings for cryptocurrencies. Part III of this Note explores the issues that plague traditional credit rating

¹⁰ See del Castillo, *supra* note 7.

¹¹ Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, § 932(a)(8), 124 Stat. 1375, 1877 (2010) (codified at 15 U.S.C. § 78 (2018)).

¹² John M. Griffin & Amin Shams, *Is Bitcoin Really Un-Tethered?*, 75 J. FIN. (forthcoming Aug. 2020) (manuscript at 47), <https://www.coindesk.com/wp-content/uploads/2019/11/SSRN-id3480263.pdf> [<https://perma.cc/8FL3-AEKG>] (discussing the problems that arise when the public is led to believe that low-quality securities are investment grade).

agencies, and how we might avoid such problems as credit agencies enter the cryptocurrency space. Part IV of this Note proposes the creation of a public cryptocurrency rating provider to avoid (or at least, minimize) the impact of conflicts of interest that plagued credit rating agencies leading up to the housing crisis, and that, to a great extent, still exist today. Lastly, Part V of this Note discusses additional cryptocurrency rating reforms that should be adopted to supplement the public agency proposal. These supplemental reforms should be considered regardless of whether Congress implements the main public agency proposal. The nascent state of cryptocurrency regulation and governmental involvement in the cryptocurrency space makes the present an appropriate time to create a well-functioning and robust cryptocurrency rating landscape. Part VI concludes.

II. BACKGROUND

A. Cryptocurrency and Blockchain Background

Before diving into the world of cryptocurrency ratings, a foundational understanding of cryptocurrency and blockchain technology is helpful. Many hear the terms Bitcoin, cryptocurrency, and blockchain used frequently, but are unsure of their meaning.

First, the simplest way to conceptualize a blockchain is to visualize a ledger, or record book.¹³ This ledger is shared among parties in a network over which there exists no single central authority in control.¹⁴ Instead of having one central authority (such as a bank), all users on the network—called “nodes”—hold an identical copy of the ledger.¹⁵ Similar to a page from a record book, a “block” consists of transactions from the same time period, hence the term “blockchain.”¹⁶

¹³ OECD, OECD BLOCKCHAIN PRIMER 4 (2018), <https://www.oecd.org/finance/OECD-Blockchain-Primer.pdf> <https://www.oecd.org/finance/OECD-Blockchain-Primer.pdf> [<https://perma.cc/7AAT-V2XK>].

¹⁴ *Id.* at 4.

¹⁵ *Id.*

¹⁶ *Id.*

Thus, the ledger is comprised of a string of blocks, which clearly memorialize completed transactions for all network participants.¹⁷

Blockchain is distributed, immutable, and agreed to by consensus.¹⁸ Blockchain is a distributed ledger, since it is not held or updated by a central authority, but rather is held and maintained by all nodes in a network.¹⁹ This system is more difficult to attack for hackers and criminals, since there is not a central database that stores the ledger's information.²⁰ Additionally, blockchain transactions are immutable, as they cannot be reversed once added to the ledger.²¹ This feature again departs from traditional databases, where authorized users can modify data without detection by other users.²² In the case of a blockchain, specific nodes in the network must approve changes to the ledger through a consensus mechanism, which outlines the rules behind such an approval process.²³ This process is key to maintaining the validity of each block in the blockchain. Blockchain's characteristics make it a wonderful tool for recordkeeping; indeed, one of blockchain's common applications involves recording balances of and transactions in "tokens."²⁴

Tokenization refers to the transferring of the rights to a real-world asset into a digital token on a blockchain.²⁵ This token can be traded and tracked digitally.²⁶ There are three main types of tokens: payment, utility, and security.²⁷ Payment tokens, also referred to as cryptocurrencies, are a unit of measurement and store of value.²⁸ Utility tokens represent

¹⁷ *Id.*

¹⁸ *Id.* at 6.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.* at 8.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

access to services or products provided by a company, similar to a gift card.²⁹ Security tokens represent an equity-like investment in a company, similar to buying shares of a company on a stock exchange.³⁰

Token transactions differ from traditional financial transactions since banks play a critical role as intermediaries for traditional financial transactions. Unfortunately, banks typically store their data on a central ledger, creating a target for hackers who may attack this single point of failure.³¹ With this issue in mind, Bitcoin was created to allow users to transfer units of value without relying on banks as middlemen.³² The lack of a central authority in control of a single ledger is the primary appeal behind Bitcoin, and certainly a large reason why many individuals advocate for cryptocurrency's widespread use.³³

After understanding the background behind cryptocurrency, discussing the fundamentals of credit rating agencies makes it easier to explore and appreciate the nuances of rating cryptocurrencies. Credit rating agencies provide ratings to certain types of securities to tell investors whether such securities have a high or low default risk.³⁴ These ratings play an important role in capital markets as they indicate to investors the value and safety of their investment.

B. Credit Rating Agency Background

Establishing a background knowledge on credit rating agencies facilitates the process of analogizing between cryptocurrency ratings and credit ratings. Credit rating agencies are specialized organizations focused on assessing the credit risk of private and public companies that seek capital markets

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Updated Investor Bulletin: The ABCs of Credit Ratings*, SEC. & EXCHANGE COMMISSION (Oct. 12, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_creditratings [<https://perma.cc/JY7L-WKL4>].

financing.³⁵ Credit rating agencies give low ratings to high-risk products and securities because the issuers are considered to have a higher likelihood of default.³⁶ Similarly, credit rating agencies give high ratings to low-risk products and securities because the issuers are fairly likely to stay solvent and meet their financial obligations.³⁷ In short, in gauging issuers' ability to meet their financial obligations credit rating agencies work to predict the chance of a financial product being repaid, in part or in whole.³⁸ Credit rating agencies are considered "gatekeepers" for financial markets.³⁹ Without offering investors quality assurance, it became hard for issuers to access capital markets, so they began paying for credit ratings, which essentially served as "seals of approval."⁴⁰

Nationally Recognized Statistical Rating Organizations ("NRSROs") are credit rating agencies registered with the Securities and Exchange Commission ("the SEC") under section 15E of the Exchange Act.⁴¹ As of January 15, 2020, there are nine credit rating agencies in the U.S. registered as NRSROs.⁴² As a result of the regulatory benefits of being designated a NRSRO, these selected rating agencies have oligopolistic control of the credit rating space.⁴³ Specifically, the

³⁵ Reyes Pariente, *What Are Rating Agencies?*, BBVA (May 4, 2017), <https://www.bbva.com/en/what-are-rating-agencies/> [https://perma.cc/66SG-XTA5].

³⁶ *Id.*

³⁷ *Id.*

³⁸ EMILY MCCLINTOCK EKINS & MARK A. CALABRIA, CATO INST., REGULATION, MARKET STRUCTURE, AND ROLE OF THE CREDIT RATING AGENCIES 3 (2012), <https://www.cato.org/publications/policy-analysis/regulation-market-structure-role-credit-rating-agencies> [https://perma.cc/5PAQ-G2XR].

³⁹ Josh Wolfson & Corinne Crawford, *Lessons from the Current Financial Crisis: Should Credit Rating Agencies be Re-Structured?*, 8 J. BUS. & ECON. RES. 85, 85–86 (2010).

⁴⁰ *Id.* at 87.

⁴¹ 15 U.S.C. § 78o-7 (2018).

⁴² SEC. & EXCH. COMM'N, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 2 (2020), <https://www.sec.gov/files/2019-annual-report-on-nrsros.pdf> [https://perma.cc/QY4B-9WYR].

⁴³ See EKINS & CALABRIA, *supra* note 38, at 19.

demand for NRSRO ratings skyrocketed as specific kinds of investors were legally required to invest in securities rated highly by NRSROs.⁴⁴ The importance of credit ratings combined with the small number of NRSROs give these specially designated rating agencies significant power through the ratings they offer. In this low competition environment, NRSROs are unlikely to improve their rating methodologies since they have little incentive to do so.⁴⁵ This is consistent with the usual view of oligopolies as inefficient and unproductive since they lack an efficient market determination of prices.⁴⁶ In the world of rating agencies, this inefficiency could lead to inaccurate ratings and methodological errors.⁴⁷

Rating agencies began with the mission of providing transparency to investors, with Moody's, the first public publisher of bond ratings, using an investor-pays business model in which firms sold bond ratings to investors.⁴⁸ Later however, credit rating agencies switched to an issuer pays model in which the issuer pays the credit rating agency to rate its bond.⁴⁹ This shift created the incentive for credit rating agencies to inflate ratings, as issuers could simply "shop" for higher ratings from other agencies.⁵⁰ The issuer pays model still exists today.⁵¹

⁴⁴ *See id.* at 8.

⁴⁵ *See id.* at 22.

⁴⁶ Jack T. Gannon, Jr., *Let's Help the Credit Rating Agencies Get It Right: A Simple Way to Alleviate a Flawed Industry Model*, 31 REV. BANKING & FIN. L. 1015, 1024 (2012).

⁴⁷ *Id.*

⁴⁸ LAWRENCE J. WHITE, MERCATUS CTR., A BRIEF HISTORY OF CREDIT RATING AGENCIES: HOW FINANCIAL REGULATION ENTRENCHED THIS INDUSTRY'S ROLE IN THE SUBPRIME MORTGAGE DEBACLE OF 2007–2008 2 (2019), <https://www.mercatus.org/publications/monetary-policy/brief-history-credit-rating-agencies-how-financial-regulation> [https://perma.cc/23Z8-4MA6].

⁴⁹ *Id.*

⁵⁰ ALICE M. RIVLIN & JOHN B. SOROUSIAN, BROOKINGS INST., CREDIT RATING AGENCY REFORM IS INCOMPLETE 2–3 (2017), <https://www.brookings.edu/research/credit-rating-agency-reform-is-incomplete/> [https://perma.cc/U3XT-J2GK].

⁵¹ *Id.*

C. The Subprime Mortgage Crisis

Overreliance on credit ratings likely played a significant role in the housing crisis of 2008.⁵² The involvement of credit rating agencies in the crisis can be understood through a chain of events:

Without those ratings, the transactions could not, and would not, have happened. Without the ability to obtain high ratings . . . there would have been little appetite for overpriced lower-rated mortgage collateral. Without that appetite, there would have been little pressure leading to the proliferation of sub-prime mortgages, because those mortgages could not have been offloaded through ‘second-level’ securitizations. Without the proliferation of low quality mortgages, there would not have been a dramatic housing market rise and fall, with the attendant ripple effects.⁵³

The motivation for comparing cryptocurrency ratings to credit ratings stems from the involvement of credit rating agencies in the subprime mortgage crisis. Hopefully, in furthering the understanding of the role credit rating agencies played in the subprime mortgage crisis, similar disasters will be averted in the future.

Currently, while cryptocurrency is still in the process of becoming mainstream, it does not yet have the level of widespread acceptance necessary to cause an economic crash like that caused by subprime mortgage backed securities in 2008. Nevertheless, credit rating agencies and other rating providers entering the cryptocurrency space could have a potentially legitimizing effect, making cryptocurrency investments more common and the impact of a possible crash greater.

⁵² See Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis*, in *THE PANIC OF 2008: CAUSES, CONSEQUENCES, AND IMPLICATIONS FOR REFORM* 116, 116 (Lawrence E. Mitchell & Arthur E. Wilmarth, Jr., eds., 2010) (“A primary cause of the recent credit market turmoil was overdependence on credit ratings and credit rating agencies.”).

⁵³ *Id.* at 129.

1. Specific NRSRO Behavior Contributing to Crash

After understanding credit rating agencies' general contributions to the housing crisis, one can better grasp the specific details of NRSROs' actions. In the lead up to the 2008 crash, NRSROs did not correctly recognize the default risks of residential mortgage backed securities ("RMBSs") and credit default obligations ("CDOs") as a result of flaws in their rating models.⁵⁴ Shockingly, the models were faulty because the NRSROs did not verify the value of the underlying assets backing the securities being rated.⁵⁵ Ultimately, the NRSROs failed to provide accurate ratings because they were incentivized to boost profits rather than determine risk.⁵⁶ This motivation ties back to the aforementioned "ratings shopping."⁵⁷

2. Dodd-Frank's Credit Rating Agency Reform

Dodd-Frank was a pivotal piece of legislation focused on preventing a future disaster like the 2008 financial crisis.⁵⁸ As part of its response to the crisis, Dodd-Frank imposed rules governing credit rating agencies, primarily focusing on increasing their transparency and accountability.⁵⁹

Most notably, Dodd-Frank directed the SEC to create an Office of Credit Ratings.⁶⁰ This office develops rules about

⁵⁴ Jeanna Simeone, *The Use of Credit Ratings for Mortgage-Backed Securities*, 31 REV. BANKING & FIN. L. 102, 104–05 (2011).

⁵⁵ *Id.* at 104–05.

⁵⁶ *Id.* at 105.

⁵⁷ *Id.*

⁵⁸ Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); *see also* Charles W. Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Prevent Future Crises?*, 64 SMU L. REV. 1243, 1246 (2011).

⁵⁹ Dodd-Frank Act § 932. *See also* CRAIG L. JOHNSON ET AL., THE IMPACT OF DODD-FRANK ON CREDIT RATINGS AND BOND YIELDS: THE MUNICIPAL SECURITIES' CASE 3 (2018), <https://www.brookings.edu/wp-content/uploads/2018/04/Johnson-C.-et-al.pdf> [<https://perma.cc/5GSX-54PW>].

⁶⁰ *About the Office of Credit Ratings*, SEC. & EXCHANGE COMMISSION (June 4, 2018), <https://www.sec.gov/ocr/Article/ocr-about.html> [<https://perma.cc/69BW-UNWC>].

agencies' internal controls and penalizes credit rating agencies for poor performance.⁶¹ Poor performance may be indicated through a failure to consistently provide accurate ratings.⁶² Nationally recognized credit rating agencies now have to maintain an internal control system and report details about its system to the SEC annually.⁶³ Going beyond external oversight, credit rating agencies must also publicly disclose their rating methodologies (and changes made to them) and their use of third parties in performing due diligence reviews.⁶⁴ These requirements are powerless if they are not enforced. Therefore, Dodd-Frank empowers the SEC to penalize credit rating agencies that fail to provide accurate ratings.⁶⁵

D. Weiss Ratings Background

A brief discussion of some cryptocurrency ratings players is valuable before discussing potential reforms to the cryptocurrency rating space. Weiss Ratings ("Weiss") is one prominent and representative player. Cryptocurrency ratings can be impactful: a recent ratings report from Weiss Ratings led a cryptocurrency called EOS to shoot up in price nearly twenty percent in just forty-eight hours.⁶⁶

Since beginning operations in 1971, Weiss has distinguished itself with its compensation model.⁶⁷ While issuers pay for ratings from Moody's, Standard & Poor's ("S&P"), and

⁶¹ David S. Huntington, *Summary of Dodd-Frank Financial Regulation Legislation*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 7, 2010), <https://corpgov.law.harvard.edu/2010/07/07/summary-of-dodd-frank-financial-regulation-legislation/> [<https://perma.cc/57XM-3VLD>].

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ Dodd-Frank Act, Pub. L. No. 111-203, § 933, 124 Stat. 1376, 1883 (2010).

⁶⁶ Billy Bambrough, *Ratings Bombshell Lifts EOS, Bitcoin, and Wider Crypto Market*, FORBES (Mar. 28, 2019), <https://www.forbes.com/sites/billy-bambrough/2019/03/28/ratings-bombshell-lifts-eos-bitcoin-and-wider-crypto-market/#7fa40d9c3780> [<https://perma.cc/5DHD-F7VQ>].

⁶⁷ *See About, WEISS CRYPTO RATINGS*, <https://weisscrypto.com/en/about> [<https://perma.cc/FG3Q-PLXN>] (last visited Mar. 8, 2020).

Fitch under an “issuer pays” model, investors, consumers, and other third parties pay for ratings from Weiss under an “investor pays” model.⁶⁸ With this compensation model, some believe that Weiss is not susceptible to the conflicts of interest that plague other rating agencies since issuers are not paying for the ratings they are receiving.⁶⁹

While Weiss started by offering ratings for traditional financial instruments like stocks, mutual funds, and exchange traded funds (“ETFs”), the company ventured into the cryptocurrency space in 2018.⁷⁰ Weiss provides a letter grade for each cryptocurrency,⁷¹ and instructs investors to interpret the grades as follows:

- A = excellent
- B = good
- C = fair
- D = weak
- E = very weak.⁷²

A F grade is given to cryptocurrencies that have failed or are subject to credible fraud allegations.⁷³ Weiss currently does not provide cryptocurrency credit ratings, which gives one traditional rating agency, Morningstar, an opportunity to enter the cryptocurrency rating space before existing credit rating agencies.⁷⁴

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ Christopher Hamman, *Morningstar Brings Blockchain into the \$117 Trillion Debt Securities Market*, COINSPEAKER (Dec. 12, 2019), <https://www.coinspeaker.com/morningstar-debt-securities-blockchain/> [<https://perma.cc/CWM9-7FBD>].

E. Morningstar Entering Cryptocurrency Rating Space

The venturing of credit rating agencies into the cryptocurrency rating space is a result of the actions of Morningstar. An established credit rating agency, Morningstar intends to soon offer a range of cryptocurrency asset rating services.⁷⁵ The company has seen massive success, generating over \$1 billion in revenue in 2018, despite only being in the ratings market for a few years.⁷⁶ For comparison, Fitch Ratings (the third largest credit rating agency) had \$1.7 billion in revenue in 2018.⁷⁷

Morningstar has decided to focus on rating debt securities in their foray into the cryptocurrency rating space.⁷⁸ On their blockchain Morningstar will include the terms of their investment contract and their credit rating for the security at issue.⁷⁹ This service appears to be valuable for investors by making it easier for individuals to evaluate the quality of their investments.⁸⁰ With a major credit rating agency entering the crypto space, reforms could begin to be imposed shortly, as “Morningstar is still not sure if the U.S. Securities and Exchange Commission will ask them to ‘enhance’ their blockchain methodology.”⁸¹

III. PROBLEMS AND CONSEQUENCES

As cryptocurrency becomes more commonplace, we next consider how to best avoid the problems created by credit rating agencies leading up to the last economic crisis. In order to craft the best solutions and make the best recommendations, it helps to start with an analysis of the potential problems that

⁷⁵ See del Castillo, *supra* note 7.

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ David Pan, *Financial Services Giant Morningstar to Offer Ratings for Crypto Assets*, COINDESK (Oct. 2, 2019), <https://www.coindesk.com/financial-services-giant-morningstar-to-offer-ratings-for-crypto-assets> [<https://perma.cc/G3U5-NAXE>].

may be created by the behavior of cryptocurrency rating providers, including market manipulation, initial coin offering (“ICO”) fraud, conflicts of interest between issuers and receivers of ratings, and influencer-related marketing fraud. Some of these potential problems differ from those facing traditional credit rating agencies, while others parallel traditional agency problems. Understanding the problems that exist, we will discuss how the reforms put into place by Dodd-Frank are insufficient to address such problems. However, to preface our discussion of reforms it will first be shown that ratings have a significant impact on cryptocurrency. If they did not, there would be little reason to recommend reforms to improve the cryptocurrency ratings paradigm.

A. Market Manipulation in the Cryptocurrency Space

One major concern surrounding cryptocurrency markets is market manipulation, whereby individuals artificially inflate or deflate the price of a security.⁸² In a recent study investigating cryptocurrency market manipulation, Professors John Griffin and Amin Shams found that between March 2017 and March 2018 Bitcoin’s price rose nearly fifty percent as a result of trades between Bitcoin and another cryptocurrency called Tether.⁸³ According to their research, Tether was used by anonymous parties to illegally inflate the price of Bitcoin over the period in question.⁸⁴ This alarming conclusion of the study prompted an investigation by federal prosecutors into

⁸² See *Fast Answers: Manipulation*, SEC. & EXCHANGE COMMISSION (Mar. 28, 2008), <https://www.sec.gov/fast-answers/answerstmanip-ulhtm.html> [<https://perma.cc/9BXA-4V5B>].

⁸³ See Griffin & Shams, *supra* note 12 (examining statistics regarding the impact of Tether on Bitcoin and other cryptocurrencies over the identified period).

⁸⁴ *Id.* at 8 (“The patterns observed . . . are consistent either with one large player purchasing Tether with cash at Bitfinex and then exchanging it for Bitcoin, or Tether being printed without cash backup and pushed out through Bitfinex in exchange for Bitcoin.”).

whether Tether was indeed used to manipulate the price of Bitcoin.⁸⁵

Most shockingly, one market player, known as “1LSg,” is thought to have been the sole culprit behind the majority of the trading patterns documented by Griffins and Shams.⁸⁶ With hundreds of cases now documented, market manipulation schemes remain a common occurrence in the cryptocurrency space.⁸⁷ As more participants enter cryptocurrency markets, the threat of a cryptocurrency price collapse grows more dire.⁸⁸ In other words, the more cryptocurrencies are relied upon by the public, the higher the stakes for their stability.

B. “Ratings Shopping” Creates a Conflict of Interest

The conflicts of interest between rating agencies and issuers are made clear by understanding first who the customer is in the private credit rating agency business model. In an issuer pays model, issuers pay a rating agency to rate their financial product.⁸⁹ It follows, then, that credit rating agencies can generate higher revenue by providing issuers with higher

⁸⁵ Matt Robinson & Tom Schoenberg, *U.S. Launches Criminal Probe into Bitcoin Price Manipulation*, BLOOMBERG (May 24, 2018), <https://www.bloomberg.com/news/articles/2018-05-24/bitcoin-manipulation-is-said-to-be-focus-of-u-s-criminal-probe> [https://perma.cc/U6HM-TSCZ].

⁸⁶ Billy Bambrough, *The Real Reason Behind Bitcoin’s Epic Rally Revealed?*, FORBES (Nov. 8, 2019), <https://www.forbes.com/sites/billybambrough/2019/11/08/real-reason-behind-bitcoins-epic-rally-revealed/#4caa100a332b> [https://perma.cc/J4JZ-WCSV] (recounting how “an unidentified Bitfinex account used Tether to manipulate the bitcoin price by creating unprecedented demand for the digital token”).

⁸⁷ See Jiahua Xu & Benjamin Livshits, *The Anatomy of a Cryptocurrency Pump-and-Dump Scheme*, 2019 USENIX SECURITY SYMP. 1609 (describing and empirically examining the phenomenon of “pump-and-dump” activities within cryptocurrency markets).

⁸⁸ See Ryan Clements, Comment, *Assessing the Evolution of Cryptocurrency: Demand Factors, Latent Value, and Regulatory Developments*, 8 MICH. BUS. & ENTREPRENEURIAL L. REV. 73, 91 (2018) (noting that increased institutional participation in the Bitcoin futures market could lead to an increase in “at-risk participation” threats and “interdependence” risks).

⁸⁹ See RIVLIN & SOROUSIAN, *supra* note 50.

ratings for their financial products. This creates an incentive for credit rating agencies to issue higher ratings regardless of their accuracy. Thus, in addition to the problem of traditional rating agencies loosening their evaluative standards to earn more business, there exists a similar, parallel problem of issuers purchasing positive ratings. Issuers of cryptocurrencies are thereby effectively able to purchase the degree of their own creditworthiness.

C. Social Media and Potential Rating Fraud Concerns

While cryptocurrency ratings are not yet extremely widespread in the U.S. economy, one area which we may analogize from is that of social media influencer marketing. Novel as it may seem, social media personalities charge thousands of dollars to provide video reviews for cryptocurrencies in exchange for payment in the cryptocurrencies they are analyzing.⁹⁰ This provides yet another massive conflict of interest in crypto markets, as reviewers are incentivized to provide positive endorsements for cryptocurrencies regardless of the actual value of the cryptocurrency being reviewed.

One specific example of how influencer endorsements can impact the perceived value of a cryptocurrency can be found in the case of Ukrainian startup “Hacken.”⁹¹ Hacken, looking to promote its new coin, found nearly 200 social media personalities in the crypto space to help them create a positive reputation.⁹² In light of the SEC’s stated view that “virtual coins or tokens may be securities and subject to the federal securities laws,” this behavior may constitute fraud.⁹³ The SEC has

⁹⁰ Anna Irrera & Elizabeth Dilts, *Special Report: Little Known to Many Investors, Cryptocurrency Reviews Are For Sale*, REUTERS (Nov. 27, 2018), <https://www.reuters.com/article/us-crypto-currencies-promoters-specialre/special-report-little-known-to-many-investors-cryptocurrency-reviews-are-for-sale-idUSKCN1NW17S> [<https://perma.cc/H2ZQ-QC2Y>].

⁹¹ *Id.*

⁹² *Id.*

⁹³ Press Release, Securities and Exchange Commission, SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities (July 25, 2017), <https://www.sec.gov/news/press-release/2017-131> [<https://perma.cc/R5Y5B-FTFC>].

gone on to provide a specific warning about ICOs, explaining that “any celebrity or other individual who promotes a virtual token or coin that is a security must disclose the nature, scope, and amount of compensation received in exchange for the promotion.”⁹⁴

D. Initial Coin Offering (“ICO”) Fraud Concerns

To illustrate another way in which fraud can be observed in crypto markets, a company called Alethena Ratings recently conducted an inquiry into just how easy it is to buy, rather than earn, a favorable ICO rating.⁹⁵ As a result of this investigation Alethena uncovered several instances of suspicious behavior, indicating the shocking ease with which biased ICO ratings may be purchased.⁹⁶

In addition to the purchasable nature of high ICO ratings, there is another concern research has highlighted, showing that the computer code behind ICOs does not properly protect investors.⁹⁷ Indeed, researchers have noted that “[f]ar from replacing (or seamlessly extending) law and norms, code is often falling short of expectations. It sometimes fails to deliver key

⁹⁴ Press Release, Securities and Exchange Commission, SEC Statement Urging Caution Around Celebrity Backed ICOs (Nov. 1, 2017), <https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos> [<https://perma.cc/42UT-Z647>].

⁹⁵ Markus Hartmann, *This Is How Easy It Is to Buy ICO Ratings—An Investigation*, MEDIUM (June 14, 2018), <https://medium.com/alethena/this-is-how-easy-it-is-to-buy-ico-ratings-an-investigation-13d07e987394> [<https://perma.cc/J368-H2MV>].

⁹⁶ *Id.* (“A closer inspection of the websites of ICObench and similar rating providers showed that ICO rating visibility is by no means impartial. In fact, it is influenced by the wallets of the respective ICOs. ICObench offers ICOs so-called premium listing services. In exchange for some Bitcoin (depending on how long the service is provided), ICOs can purchase a top ranking in the ICO overview, be featured in the newsletter, and also be positioned on the profile pages of their competitors. At the same time, these competitors will be blocked from appearing on the profile pages of paying ICOs.”).

⁹⁷ Shaanan Cohn, et al., *Coin-Operated Capitalism*, 119 COLUM. L. REV. 591, 659 (2019) (demonstrating generally that “the current structures—markets, formal organizations, and professional communities—where ICOs take place are producing a disconnect” between “technolibertarian beliefs” and “actual ICO practices”).

investor protections, and can provide founders with significant, undisclosed authority to alter the terms of investor engagement.”⁹⁸ This concern only magnifies the problem of purchasing ICO ratings, seeing as fraudulent ICOs can simply pay to receive high ratings despite consisting of a shoddy underlying technical framework. Indeed, the “hackable” reputation of ICOs through websites like ICObench should be especially concerning for investors who rely on such ratings as an indicator of value.⁹⁹

E. Dodd-Frank Did Not Fix the Aforementioned Problems

The goal was to encourage rating agencies to provide unsolicited ratings to issuers, and to push back on issuers’ influence over rating agencies.¹⁰⁰ Unfortunately, the SEC’s current approach is not working.¹⁰¹ The problem is that such unsolicited ratings have rarely been provided, most likely due to credit rating agencies’ fear that they might anger issuers and lose business in the process.¹⁰²

Dodd-Frank mandates that the SEC study and review the standardization of credit ratings.¹⁰³ This push for standardization is likely to encounter resistance given that rating providers make a business of offering their own unique rating services to the market. If standardization were to occur, one might wonder how firms would distinguish themselves. Perhaps individualization would occur by additional services being offered, since rating agencies could presumably no longer offer a rating for a price.

⁹⁸ *Id.*

⁹⁹ *Id.* at 649.

¹⁰⁰ See Cezary Podkul, *SEC Fix for Conflicts of Interest at Credit-Ratings Firms Has Failed*, WALL ST. J. (Oct. 29, 2019), <https://www.wsj.com/articles/sec-fix-for-conflicts-of-interest-at-credit-ratings-firms-has-failed-11572341401> [<https://perma.cc/T646-NA6D>].

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ Dodd-Frank Act, Pub. L. No. 111-203, § 932, 124 Stat. 1376, 1875 (2010).

Still, Dodd-Frank has been heavily criticized for not doing enough to reform the credit rating process after the last economic crisis, as seen in an article titled, *What's (Still) Wrong with Credit Rating Agencies*.¹⁰⁴ The primary message of the article is that the credit rating reforms implemented by Dodd-Frank were failures, and thus the same risks that led to the 2008 crisis remain as market vulnerabilities.¹⁰⁵ The author, Frank Partnoy, derides ratings as a concept, noting that:

Letter ratings are a crude mechanism for information intermediation. Letter ratings obscure the analysis of the key variables that matter in the analysis of credit: probability of default, expected recovery in the event of default, and the correlation of defaults. The methodologies I critique in this article are disconnected from that analysis. If the markets experience another crisis related to credit ratings, and ratings prove again to have been 'garbage out,' then during the next regulatory response it will be important to understand more clearly the role of the 'garbage in' (i.e., rating agency methodology).¹⁰⁶

The rating methodology Partnoy disparagingly refers to is key for the public to understand if they are to continue to safely rely on ratings. Since ratings are not likely to fade out of use entirely, perhaps a practicable system is one where rating oversight occurs, creating an environment in which investors can feel comfortable relying on ratings as a part of their investment process. Rating oversight is particularly applicable to the world of cryptocurrency where there are not many consistently reliable sources that assess the value of specific cryptocurrencies.¹⁰⁷

¹⁰⁴ Frank Partnoy, *What's (Still) Wrong with Credit Ratings*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 31, 2017), <https://corpgov.law.harvard.edu/2017/05/31/whats-still-wrong-with-credit-ratings/> [https://perma.cc/KJ4Z-PEX2].

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ Tom Goldenberg, *The Hard Thing About Crypto Price Valuation*, COINDESK (Feb. 15, 2018), <https://www.coindesk.com/hard-thing-crypto-valuation> [https://perma.cc/SZ6A-AMTB].

IV. PROPOSED SOLUTION – CREATING A PUBLIC AGENCY TO PROVIDE CRYPTO RATINGS

A. Justification for Proposed Solution

This Note proposes that the United States create a public agency to provide ratings for cryptocurrencies without bias or conflicts of interest present. While this may seem to be a difficult task, acknowledge that Weiss already refuses to accept compensation of any kind from the entities it rates, thereby eliminating a disruptive conflict of interest.¹⁰⁸ On the issue of rating accuracy, the Government Accountability Office reported that Weiss' ratings of life and health insurers better reflected financial vulnerability than those of Moody's and S&P.¹⁰⁹ However, the existence of Weiss does not remove the need for a public agency in the crypto rating space—Weiss still operates as a private company, and has previously been under SEC scrutiny for distributing “materially false and misleading marketing materials.”¹¹⁰

B. Learning from Credit Rating Agencies

Several commentators have proposed the public agency solution for credit rating agencies.¹¹¹ The appeal of a public credit rating agency centers around promoting transparency.¹¹² In the view of those who have advocated for a public agency's creation, a public agency wouldn't eliminate the need for private agencies.¹¹³ Instead, “private agencies would be free to continue operating . . . [b]ut when their appraisals

¹⁰⁸ See *supra* Section II.D.

¹⁰⁹ U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-94-204BR, INSURANCE RATINGS: COMPARISON OF PRIVATE AGENCY RATINGS FOR LIFE/HEALTH INSURERS 2 (1994).

¹¹⁰ Weiss Research, Inc., Exchange Act Release No. 60125, 2009 WL 1684731, at *1 (June 17, 2009).

¹¹¹ M. Ahmed Diomande et al., *Why U.S. Financial Markets Need a Public Credit Rating Agency*, ECONOMISTS' VOICE, June 2009, at 1.

¹¹² *Id.* at 2.

¹¹³ *Id.* at 2–3.

differ significantly from those provided by the public agency, the private agencies would be forced to explain the basis for their divergent assessments.”¹¹⁴

Many individuals are currently pushing for innovation in the nascent crypto landscape.¹¹⁵ While established rating agencies have achieved near oligopolistic control of the credit rating market, similar dominance and control has not yet been observed in the crypto ratings market. As players like Morningstar begin to issue cryptocurrency ratings, the need for scrutiny of crypto ratings is an urgent concern, given that other major credit rating agencies may follow suit and enter the space.

A public crypto rating agency would serve as a corrective force for the rampant conflicts of interest that currently plague credit ratings.¹¹⁶ A public crypto rating agency would allow financial markets to operate with more transparency, and thus would enable investors to make more informed decisions. Such transparency would come from the benchmark an unconflicted public actor would provide.

Additionally, to protect investors a public agency could be empowered to decide that certain financial instruments are too complex to properly assess.¹¹⁷ Private rating agencies are unlikely to admit that an instrument is “not ratable” because of the incentives inherent in the issuer pays compensation model.¹¹⁸

As noted above, the recommendation of having a public agency does not necessarily entail eliminating private rating providers. Such an endeavor seems unrealistic given private agencies’ current presence and likely future involvement in the cryptocurrency rating space. Nevertheless, the presence of a public agency would at the very least offer an additional

¹¹⁴ *Id.* at 3.

¹¹⁵ George Nethercutt, *Washington Must Defend American Crypto Innovation, Not Crush It*, HILL (Jan. 14, 2019), <https://thehill.com/opinion/technology/425225-washington-must-defend-american-crypto-innovation-not-crush-it> [<https://perma.cc/2CJ7-AYC8>].

¹¹⁶ *See supra* Section III.B.

¹¹⁷ *See* Diomande et al., *supra* note 111, at 2.

¹¹⁸ *See* RIVLIN & SOROUSHIAN, *supra* note 50.

source of information investors could rely upon in making financial decisions.

C. Operating Details of Proposed Public Agency

The proposed public agency could operate by requiring that all cryptocurrency issuers obtain a rating from the agency before their cryptocurrencies could be legally traded. If this is considered to be too extreme, then at the very least the ratings of the public agency could serve as a point of comparison with those of the private agencies. Generally, research indicates that “rating agencies not only publish more, but also more accurate information in [the] case of multiple ratings.”¹¹⁹ This research indicates that additional rating data points provided by a public agency could help improve the accuracy of ratings provided by private actors.

Some might argue that competition between private agencies would solve these problems, but unfortunately the issuer pays model creates conflicts of interest that do not incentivize private rating agencies to compete to develop the most accurate rating methodology.¹²⁰ Instead, most private actors are stuck in a profit-driven mindset that distracts them from the realities of the economy. In contrast to the existing rating agency incentive structure, a public agency would not receive any benefits from offering high or low ratings, and thus conflicts of interest would be minimized.

V. EVALUATING POTENTIAL REFORMS TO SUPPLEMENT THE PROPOSED SOLUTION

In order to make a real impact on the cryptocurrency rating process, additional reforms should supplement the creation of a public rating agency. However, these reforms are useful regardless of whether a public agency is created. As discussed in Section III.B, the issuer pays model creates

¹¹⁹ Stefan Morkoetter et al., *Competition in the Credit Rating Industry: Benefits for Investors and Issuers*, 75 J. BANKING & FIN. 235, 236 (2017).

¹²⁰ See *supra* Section III.B.

significant conflicts of interest that result in an incentive structure that does not reward accuracy.¹²¹

One proposal that would address this incentive problem is to remove credit ratings altogether.¹²² However, it is extremely unlikely that private rating providers will disappear, largely because they serve as gatekeepers to capital markets.¹²³ Thus, it is important to assume that private rating providers will continue to exist. Since the removal of private rating agencies is unlikely to occur, we must work to improve the current ratings framework, regardless of whether a public cryptocurrency rating agency is ever actually created.

A. Applying Dodd-Frank Credit Rating Reform to Cryptocurrency Rating Providers

One approach to supplemental reform lies in looking at how Dodd-Frank's credit rating reforms may be relevant to cryptocurrency rating providers. The argument is not that all Dodd-Frank provisions relevant to credit rating agencies should be blindly applied to the cryptocurrency space. Instead, crypto rating providers may be able to learn from specific sections of Dodd-Frank in ensuring that the value and legitimacy of a currency is represented through fair ratings.

Section 933 of Dodd-Frank is especially relevant to cryptocurrency rating providers. This is not to say that other sections of Dodd-Frank should not be applied to cryptocurrency rating providers, but just that section 933 provides a useful example of how such applications can be made. Section 933

¹²¹ See *id.* See also Joseph William Singer, *Foreclosure and the Failures of Formality, or Subprime Mortgage Conundrums and How to Fix Them*, 46 CONN. L. REV. 497, 556 (2013) ("The current system puts the rating agencies in the pocket of the securitizing banks and gives them incentives to mislead investors. It would be better if incentives could be changed to put the rating agencies on the side of the investors rather than the sellers of securities. And if that is not possible, then they should be replaced by a professional, expert public agency.")

¹²² Christopher C. Nicholls, *Public and Private Uses of Credit Ratings* (Aug. 1, 2005) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1625839 [<https://perma.cc/5RL9-K9U8>].

¹²³ See Wolfson & Crawford, *supra* note 39, at 87.

addressed the issue of whether statements made by credit rating agencies were “forward-looking” and thus exempt from liability.¹²⁴ While such statements were previously considered to be forward-looking and exempt, section 933 reversed course by deeming credit rating agency statements “statements made by a registered public accounting firm or a securities analyst under the securities laws.”¹²⁵ This language effectively created a private right of action against credit rating agencies.¹²⁶ Applying this section to cryptocurrency rating providers could disincentivize inaccurate ratings and fraudulent behavior. As cryptocurrency ratings become more prominent, further research should be conducted into whether Dodd-Frank’s credit rating reforms should be applied to cryptocurrency rating providers.

B. SEC Reform Should Extend Beyond Current State to Help Small Rating Providers Compete

Next steps could involve providing smaller rating agencies in the crypto space a more meaningful opportunity to compete in the ratings market. Concern for the future of cryptocurrency ratings stems from the problems observed in the operation of traditional credit rating agencies. Currently, the ratings market is dominated by a few large credit rating agencies, which effectively prevents smaller agencies from competing or surviving. Consider the example of Egan-Jones, a small ratings company that adopted an investor-pays compensation model.¹²⁷ Operating with an incentive structure designed only to protect investors, Egan-Jones has proven the remarkable accuracy of its ratings. Indeed, in 2008 “Egan-

¹²⁴ Dodd-Frank Act, Pub. L. No. 111-203, § 933, 124 Stat. 1376, 1883 (2010).

¹²⁵ *Id.* See also 17 C.F.R. § 230.175 (2019).

¹²⁶ *Id.* See also Allana M. Grinshteyn, Note, *Horseshoes and Hand Grenades: The Dodd-Frank Act’s (Almost) Attack on Credit Rating Agencies*, 39 HOFSTRA L. REV. 937, 955 (2011).

¹²⁷ Stephen Moore, Opinion, *Credit Rating Agencies Running a Racket*, BOS. HERALD (Oct. 11, 2018), <https://www.bostonherald.com/2018/10/11/credit-rating-agencies-running-a-racket/> [<https://perma.cc/D6KM-TR27>].

Jones was one of the first to sniff out the ticking time bombs of mortgage-backed securities that the others were saying were completely free of risk. Egan-Jones also beat S&P and Moody's in downgrading Bear Stearns and Lehman Brothers before they became the first two firms to collapse in the wake of the meltdown."¹²⁸ Commentators have reflected on the performance of Egan-Jones by arguing that "[w]hat is desperately needed is a new model where the credit raters work for the investors and where there are many competitors to choose from."¹²⁹

Another solution that could address the oligopoly problem in the credit rating arena could be getting rid of the NRSRO designation altogether.¹³⁰ Policy analysts have indicated that an oligopoly has been created through the NRSRO system.¹³¹ Such an oligopoly can negatively impact the productivity of the profit-driven credit rating agencies.¹³² Specifically, analysts have argued that, as a result of NRSRO designations the credit rating agency market should be expected "to be generally resistant to competitive pressure, be dominated by few firms, have high profits, and have restricted output supplied."¹³³ Additionally, the same authors went on to explain that "[w]ithout the threat of competition, oligopolistic CRAs are likely to become more complacent in their methodologies. Also, with fewer firms and reduced competition, markets may find it less likely to discover new tools to better measure credit risk."¹³⁴

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ See EKINS & CALABRIA, *supra* note 38, at 12 ("Although reputational factors create some natural barriers to entry in the CRA market, most of the barriers to entry result from the regulatory designation of NRSRO CRAs.").

¹³¹ *See id.*

¹³² *See id.* It should be noted that, in the context of the credit rating agency market, "[r]estricted output supplied can be in terms of informational output (quality as a dimension of quantity), rather than the sheer number of ratings produced." *Id.*

¹³³ *Id.*

¹³⁴ *Id.*

Getting rid of the NRSRO system is easier said than done. In fact, some of the existing literature that has considered the public agency proposal also has acknowledged that there appears to be minimal support for the abolishment of the NRSRO designation.¹³⁵ Nevertheless, elimination of the designation should be striven for in hopes of allowing smaller rating providers to compete, and encouraging the provision of more accurate ratings.

C. Implementing Incentive-Based Compensation for Rating Agencies

Incentive-based compensation for rating agencies is one potential approach that may be pursued to address the issue of inaccurate ratings. Current reforms' focus on rating agency liability may ironically lead to less accurate ratings, as liability exposure does not necessarily incentivize rating agencies to rate accurately.¹³⁶ Rather, under section 933's liability regime, agencies are incentivized to simply avoid negligence.¹³⁷ However, the incentive structure of agencies could be addressed by shifting away from the issuer pays framework toward an incentive-based compensation model. An interesting essay explores this idea, proposing that credit rating agencies be paid by the debt they rate.¹³⁸ In this scheme, "[i]f a CRA overrates debt, then the CRA suffers a financial penalty because the debt the CRA receives as compensation is less valuable than the cash compensation that the debt is replacing."¹³⁹ Tying the compensation of rating agencies to the success of the debt instruments they rate may encourage the provision of more accurate ratings.

¹³⁵ See Nicholls, *supra* note 122.

¹³⁶ Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. REG. 91, 113 (2010).

¹³⁷ *Id.*

¹³⁸ *Id.* at 91.

¹³⁹ *Id.*

An additional form of incentive-based compensation could involve tax credits.¹⁴⁰ Under this scheme, private rating agencies that accurately assess the risk of a financial instrument could be rewarded with tax credits.¹⁴¹ This proposal would first require developing a measure of ratings accuracy and setting accuracy benchmarks that rating providers must meet to receive credits.¹⁴² In offering a positive incentive for accurate ratings, rating agencies would be incentivized to rate accurately, ideally counteracting the conflict of interest intrinsic to the issuer pays model.¹⁴³

D. Proposing Additional Factors for Cryptocurrency Rating Providers to Consider

An additional focus of reform could be the rating process itself. The challenge presented in reforming the ratings process is a lack of complete transparency into the methodologies used by cryptocurrency rating providers. Although it would be unrealistic to expect companies like Weiss and Morningstar to disclose their entire rating methodology, a better understanding of what factors are used in cryptocurrency ratings could allow for better future policy recommendations to improve the ratings process.

An additional, more unique factor to take into account is the presence of an environmental risk metric.¹⁴⁴ Oftentimes, the mining process behind cryptocurrencies is extremely energy intensive, leading to large monetary and environmental costs.¹⁴⁵ As a result, some cryptocurrencies may be harder to

¹⁴⁰ Timothy E. Lynch, *Deeply Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 301 (2009).

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ Kate Duguid, *Fitch Adds Environmental Risk Metric to Mortgage-backed Securities Ratings*, REUTERS (June 5, 2019), <https://af.reuters.com/article/energyOilNews/idAFL2N23C1C4> [<https://perma.cc/YY6H-FRR3>].

¹⁴⁵ Alex Hern, *Bitcoin's Energy Usage is Huge – We Can't Afford to Ignore It*, GUARDIAN (Jan. 17, 2018),

adopt on a global scale as society becomes more aware of the environmental consequences of its actions. Weiss, for example, currently factors “energy efficiency” into its cryptocurrency rating formula.¹⁴⁶

VI. CONCLUSION

With the move of Morningstar into the crypto rating space, now is the time to consider how lessons learned from credit rating agencies and Dodd-Frank can be applied to improve the accuracy of cryptocurrency ratings. The role that credit rating agencies played in causing the 2008 economic crisis cannot be denied. Thus, if cryptocurrencies are to achieve the level of prominence that other mainstream securities have enjoyed, investors must be confident in their value. To establish the requisite level of confidence, investors will increasingly rely on cryptocurrency ratings, making it even more important that such ratings properly characterize crypto assets.

The lens through which we view the problem presented by rating cryptocurrencies is critical. Instead of waiting passively for issues to arise and responding reactively, we should place increased scrutiny on cryptocurrency issuers and rating providers now. We must also change incentives for rating providers to ensure that conflicts of interest are minimized and ratings are accurate. The current system incentivizes rating providers to mislead investors by teaming up with issuers. Ideally, incentives should shift towards putting rating agencies on the side of issuers, perhaps by creating a public crypto rating agency.

While entirely replacing private crypto rating agencies is not essential, it is critical that the reforms adopted address the rampant conflicts of interest present in the cryptocurrency ratings world so that the crypto ratings ultimately issued can be trusted to provide a reliable source of information for investors.

<https://www.theguardian.com/technology/2018/jan/17/bitcoin-electricity-usage-huge-climate-cryptocurrency> [<https://perma.cc/9C7T-NFFL>].

¹⁴⁶ See *About*, *supra* note 67.