RHETORIC AND THE REGULATION OF THE GLOBAL FINANCIAL MARKETS IN A TIME OF CRISIS: THE REGULATION OF CREDIT RATINGS

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The collapse of the US sub-prime lending market and of the transnational market for mortgage backed securities raises some fundamental questions about the effectiveness of regulation of financial firms and markets. In response to the crisis, domestic and supranational regulators and standard-setters have focused attention in particular on the regulation of credit rating agencies. The paper will compare the ways in which public authorities in the US and the EU have regulated and are proposing to regulate CRAs. In particular, the paper will examine the ways in which regulators and market participants are using rhetorical devices to try to frame the debates over regulation in this time of crisis.

INTRODUCTION

The financial turmoil which began with a credit crunch in the summer of 2007[1] developed into a massive global loss of confidence in the ability of the world's financial markets to value financial assets appropriately.[2] Assets underlying asset-backed securities programs, initially sub-prime loans, performed less well than the ratings of the

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[1] Bank for International Settlements, 78th Annual Report 1 April 2007 – 31 March 2008, 3 (Jun. 30, 2008) *available at* http://www.bis.org/publ/arpdf/ar2008e.pdf ("The simmering turmoil in financial markets came to the boil on 9 August 2007.") On the development of the turmoil, see also, e.g., Financial Stability Forum, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, (Apr. 2008) *available at* http://www.fsforum.org/publications/r_0804.pdf (Enhancing Resilience).

[2] *Cf.* Basle Committee on Banking Supervision, Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices, 1 Consultative Document (Nov. 2008) *available at* http://www.bis.org/publ/bcbs145.pdf ("BCBS Supervisory Guidance")("Over the past year, risk management and reporting issues related to bank valuations of complex or illiquid financial instruments, and the implications for regulatory capital requirements and bank supervision, have received considerable attention. The application of fair value accounting to a wider range of financial instruments, together with experiences from the recent market turmoil, have emphasised the critical importance of robust risk management and control processes around the measurement of fair values and their reliability.")

securities would have predicted.[3] Uncertainties about sub-prime loan backed securities infected securities backed by other financial assets, leading to a generalized lack of confidence in financial asset prices, and a reduction in banks' willingness to lend.

Domestic authorities and transnational bodies have responded to the crisis in the financial markets by nationalizing financial institutions,[4] revising deposit guarantee schemes,[5] and proposing major changes to financial regulation.[6] Commentators have

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[3] *See, e.g.*, Enhancing Resilience, *supra* note 1, at 5 ("The pooling and tranching of credit assets generated complex structured products that appeared to meet the credit rating agencies' (CRAs') criteria for high ratings.")

[4] *See, e.g.*, House of Commons Treasury Sub-Committee, Administration and Expenditure of the Chancellor's Departments, 2007–08, HC 35 at 12 (Jan 23, 2009) *available at* http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/35/35.pdf ("The nationalisation of Northern Rock, and the subsequent nationalisation of Bradford & Bingley, has created governance responsibilities for the Treasury while these entities remain under temporary public ownership."); Asli Demirguc-Kunt & Luis Serven, Are all the sacred cows dead ? implications of the financial crisis for macro and financial policies, World Bank Development Research Group, Policy Research working paper No. WPS 4807, 11 (Jan. 2009) ("Given the intensity of this crisis, direct interventions in the financial system have been so massive that by the end of 2008, governments will be the largest shareholders in most developed economies' financial industries, reversing a trend of state retreat over the last 20 years.") *Cf.* Communication from the Commission — the Recapitalisation of Financial Institutions in the Current Financial Crisis: Limitation of Aid to the Minimum Necessary and Safeguards Against Undue Distortions of Competition, OJ No. C 10/2 at 3 (Jan. 15, 2009) {"State recapitalisation may also be an appropriate response to the problems of financial institutions facing insolvency as a result of their particular business model or investment strategy. A capital injection from public sources providing emergency support to an individual bank may also help to avoid short term systemic effects of its possible insolvency. In the longer term, recapitalisation could support efforts to prepare the return of the bank in question to long term viability or its orderly winding-up.").

[5] *See, e.g.*, Directive 2009/14/EC Amending Directive 94/19/EC on Deposit-guarantee Schemes as Regards the Coverage Level and the Payout Delay, O.J. No. L 68/3 (Mar. 13, 2009); Sebastian Schich, Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects, 95 Financial Market Trends (OECD 2008/2) *available at* http://www.oecd.org/dataoecd/36/48/41894959.pdf.

[6] *See, e.g.*, G20, Declaration of the Summit on Financial Markets and the World Economy, (Nov. 15, 2008) *available at* http://www.ue2008.fr/webdav/site/PFUE/shared/import/1115_sommet_crise_financiere/declaration_washington_en.pdf ; Dominique Strauss-Kahn, A Systemic Crisis Demands Systemic Solutions, September 22, 2008, *available at* http://www.imf.org/external/np/vc/2008/092208.htm; House of Lords, European Union Committee, EU Legislative Initiatives in Response to the Financial Turmoil, 5, HL 3 2008-9 (Dec. 15 2008) *available at* http://www.publications.parliament.uk/pa/ld200809/ldselect/ldeucom/3/3.pdf ("Reform of supervisory frameworks, at both a European and a global level, has been a key issue in the wake of the recent events."), The High Level Group on Financial Supervision in the EU, Report (Feb. 25, 2009) available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (De Larosière Report); FSA, The Turner Review: A Regulatory Response to the Global Banking Crisis (Mar. 2009) *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

suggested that a combination of different factors led to the crisis.[7] However, for those who are working on developing solutions and effective regulation for the future, credit rating agencies (CRAs) are a particular focus of attention around the world,[8] because of the way in which the market turmoil developed.[9] CRAs assess the risk of providing credit to issuers of securities, set criteria for rating asset-backed securities, and assign credit ratings to asset-backed securities. In many cases the very good credit ratings CRAs assigned to particular securities turned out to be misleading.[10] As CRAs have

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[7] *See, e.g.*, Adrian Blundell-Wignall, Paul Atkinson & Se Hoon Lee, The Current Financial Crisis: Causes and Policy Issues, 95 Financial Market Trends 5 (OECD 2008/2) *available at* http://www.oecd.org/dataoecd/47/26/41942872.pdf.

[8] *See, e.g.*, EU Commission, Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies, 2, COM (2008) 704 (Nov. 12, 2008), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0704:FIN:EN:PDF (Proposed CRA Regulation) ("It is commonly agreed that credit rating agencies contributed significantly to recent market turmoil by underestimating the credit risk of structured credit products. The great majority of subprime products were given the highest ratings, thereby clearly underestimating the major risks inherent in those instruments. Furthermore, when market conditions worsened, the agencies failed to adapt the ratings promptly." See also European Parliament legislative resolution of 23 April 2009 on the proposal for a regulation of the European Parliament and of the Council on Credit Rating Agencies, *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2009-0279&language=EN&ring=A6-2009-0191#BKMD-56;Review of Credit Rating Agencies and Research Houses, A joint report by the Treasury and the Australian Securities and Investments Commission (Oct. 2008) *available at* http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep143.pdf/$file/rep143.pdf; Consultation Paper of The Canadian Securities Administrators, Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada, (Oct. 2008) *available at* http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part1/csa_20081006_11-405_abcp-con-paper.pdf.. See also, however, Blundell-Wignall et al., *supra* note 7, at 5 (arguing that banks' changed business models were important causes of the crisis).

[9] *See, e.g.,* GAO, Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System, 23, GAO - 09-216 (Jan 2009) *available at* http://www.gao.gov/new.items/d09216.pdf ("in the last few decades, various entities—nonbank lenders, hedge funds, credit rating agencies, and special-purpose investment entities—that are not always subject to full regulation by such authorities have become important participants in our financial services markets. These unregulated or less-regulated entities can provide substantial benefits by supplying information or allowing financial institutions to better meet demands of consumers, investors or shareholders but pose challenges to regulators that do not fully or cannot oversee their activities.")

[10] *See, e.g.*, Sec. & Exch. Comm'n, Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies, 2 (Jul. 2008) *available at* http://www.sec.gov/news/studies/2008/craexamination070808.pdf (SEC Study) ("The rating agencies performance in rating these structured finance products raised questions about the accuracy of their credit ratings generally as well as the integrity of the ratings process as a whole").

become a central feature of the regulation of the financial markets, relied on by banking regulators and securities regulators, inadequacies in their ratings are significant.[11] In November 2008 the G20 committed to "exercise strong oversight over credit rating agencies".[12]

Concern about the accuracy of credit ratings surfaced after the collapse of Enron and other large corporates at the beginning of the century, but at that point financial firms successfully lobbied for a version of regulation of CRAs which could be characterized as partly self-regulatory.[13] By late 2008 self-regulatory mechanisms (generally, and with respect to CRAs) were under challenge.[14] The EU Commission denounced a "manifest failure of self-regulatory efforts, both formal and informal, to ensure high standards of independence, integrity and professional diligence" in CRAs.[15]

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[11] *See, e.g.*, Lawrence J. White, *A New Law for the Bond Rating Industry*, REGULATION 48 - (Spring 2007).

[12] Declaration of the Summit on Financial Markets and the World Economy (Nov. 15, 2008) *available at* http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html. See also Communiqué of the Meeting of Finance Ministers and Central Bank Governors (Mar. 14, 2009) *available at* http://www.g20.org/Documents/2009_communique_horsham_uk.pdf; Declaration on Strengthening the Financial System (Apr. 2, 2009) *available at* http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf.

[13] For example, §4 of the Credit Rating Agency Reform Act of 2006, Pub. L. 109-291 (Sept. 29, 2006), 120 Stat. 1327, inserting a new section 15E in the Securities Exchange Act at 15 USC §78o—7, prohibits the SEC from establishing a business model for CRAs. ("The rules and regulations that the Commission may prescribe pursuant to this title, as they apply to nationally recognized statistical rating organizations, shall be narrowly tailored to meet the requirements of this title applicable to nationally recognized statistical rating organizations. Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings"). *See also, e.g.*, White, *supra* note 11, at 52.

[14] *See, e.g.*, Financial Services Authority, Regulating Retail Banking Conduct of Business, 4-5, Consultation Paper 08/19 (Nov. 2008) *available at* http://www.fsa.gov.uk/pubs/cp/cp08_19.pdf (proposing a move away from self-regulation in the context of retail banking); EU Commission, Working Document of the Commission Services (DG Internal Market) Consultation Paper on Hedge Funds, 2, 7 (Dec. 2008) *available at* http://ec.europa.eu/internal_market/consultations/docs/hedgefunds/consultation_paper_en.pdf.

[15] EU Commission, Consultation on Policy Proposals Regarding Credit Rating Agencies, 2 (Jul. 2008) (EU CRA Consultation) *available at* http://ec.europa.eu/internal_market/consultations/docs/securities_agencies/consultation-cra-framework_en.pdf.

In late 2008 the EU Commission proposed a new regulation on CRAs,[16] and the SEC acted to improve regulatory oversight of CRAs.[17]

The new rules regulators are adopting and proposing to regulate CRAs in the EU and the US are similar, as a result of cross-border co-ordination. This is understandable because of the global nature of the crisis in the financial markets and because ratings applied by CRAs have a transnational effect.[18] However, although this policy co-ordination is in one sense unsurprising, in another sense it is novel in its concreteness. Until now, harmonization of standards of financial regulation has often been accomplished through non-binding standards generated by bodies such as IOSCO (the International Organisation of Securities Commissions). Such standards have been implemented differently by different states.[19] Standards which are formally hortatory do derive greater force where international financial institutions (IFIs) such as the IMF encourage governments to adopt them,[20] and IMF Reports do focus on the details of borrowers' systems of financial regulation.[21] As a practical matter, as states act to implement supranational standards at the domestic level, they have a significant

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[16] See *supra* note 8.

[17] Sec. & Exch. Comm'n, Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6456 (Feb. 9, 2009) (NRSRO 2009 Adopting Release). The SEC adopted the new regulations at the end of 2008. See Sec. & Exch. Comm'n, Press Release, SEC Approves Measures to Strengthen Oversight of Credit Rating Agencies (Dec. 3, 2008) *available at* http://www.sec.gov/news/press/2008/2008-284.htm.

[18] *See, e.g.*, Fitch Ratings, Comments on European Commission Draft Directive/Regulation with respect to the Authorisation, Operation and Supervision of Credit Rating Agencies, 2 (Sept. 5, 2008) *available at* http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/citizens/fitchpdf/_EN_1.0_&a=d ("the rating agency business is a global business").

[19] *See, e.g.*, D. E. Alford, 'Core Principles for Effective Banking Supervision: an Enforceable International Financial Standard?', 28 *Boston College International and Comparative Law Review*, 2005, p. 237 at p. 286 ("because the agreements are not legally enforceable, nations can vary in their own interpretation and implementation of the standards.")

[20] *See, e.g.*, *id.* at pp. 286-289.

[21] *See, e.g.*, IMF, Iceland: Financial System Stability Assessment—Update, IMF Country Report No. 08/368 (Dec. 2008) *available at* http://www.imf.org/external/pubs/ft/scr/2008/cr08368.pdf.

amount of discretion to adapt the standards to local conditions. The recent financial market crisis has led to a greater commitment to cross-border policy co-ordination and intensified transnational discussions among domestic regulators and the international financial institutions.[22]

I have argued that financial firms and the trade associations which represent them have for some time used two inter-linked rhetorical strategies to influence the development of transnational financial regulation, which I have called harmonization rhetoric and market protection rhetoric.[23] For financial firms and FTAs, harmonization rhetoric has in the past urged rules in one domestic jurisdiction should not be stricter than those in another.[24] Market protection rhetoric relies on claims of expertise, and urges that regulators from outside the financial markets should not interfere with the proper functioning of those markets.[25] These two rhetorical categories are often linked

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[22] *See, e.g.*, FSF, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, Follow-up on Implementation, 4 (Oct. 2008) *available at* http://www.fsforum.org/press/pr_081009f.pdf (FSF Follow-up) (describing the recommendations in its April report (see *supra* note 1) and noting "An exceptional amount of implementation work by national authorities and international bodies is underway, as well as several parallel initiatives in the private sector that can complement official action.") *See also, e.g.*, *id.* at 21("The FSF is working to follow these national and regional initiatives and facilitate coordination as necessary to ensure a globally consistent approach to oversight and regulation of CRAs and avoid a fragmentation of CRAs' role across financial markets") and 25 ("As part of their efforts to respond to the turmoil, international regulatory, supervisory, and central bank committees have adjusted priorities and accelerated their work timetables in line with FSF recommendations, as described in detail in the other parts of this report. Standard setters have also worked jointly in areas of common interest, for instance in the case of joint BCBS-IOSCO work on strengthening capital requirements for trading books exposures.")

[23] *See, e.g.*, Caroline Bradley, *Financial Trade Associations and Multilevel Regulation*, in Ramses Wessel, Andreas Follesdal & Jan Wouters eds., MULTILEVEL REGULATION AND THE EU: THE INTERPLAY BETWEEN GLOBAL, EUROPEAN AND NATIONAL NORMATIVE PROCESSES (2008).

[24] *See, e.g.*, ISDA, Press Release, *ISDA Commends Basel Committee on New Capital Accord*, June 28, 2004, *available at* http://www.isda.org/press/press062804.html (noting, for example, that the Revised framework contains much scope for the exercise of national discretion which could result in inconsistent approaches in different jurisdictions). Within the EU, harmonisation rhetoric often includes arguments that domestic regulators should not "gold-plate" EU directives.

[25] *See, e.g.*, SIFMA, Comments on Proposal for a Regulatory Framework for CRAs and Embedded Ratings Policy Options (Sept. 5, 2008) *available at* http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/citizens/consultationpdf/_EN_1.0_&a=d (" While political pressure to act decisively may be considerable, continuing economic instability suggests that regulators should proceed deliberately and with a particular appreciation of the global context in which they act. Unless they are carefully designed to be focused and

by those who use them to discourage invasive regulation. However, crises complicate regulatory policy-making by politicizing realms which in other times belong to technocrats and those they regulate.[26] Politicians may tend to emphasize domestic politics rather than transnational co-operation.[27] In the current climate there is a risk that even if arguments for greater regulatory harmonization succeed, they may lead to more, rather than less, regulation.[28]

This paper examines the ways in which CRAs and other market participants have used market protection rhetoric and harmonization rhetoric before and after the recent crisis in the financial markets. As criticisms of pre-crisis financial regulation have proliferated one might have expected CRAs and others to be less forceful in their resort

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proportionate, legitimate measures intended to address market failures or information disparities may cause other, equally unfortunate problems. For instance, superfluous, opaque, or burdensome provisions tend to increase costs, introduce market distortions and create unnecessary barriers to entry. Imprecise or overly intrusive regulation might further endanger an industry that has an important part to play in restoring confidence in and stability to the global financial markets. Should regulation produce any of these effects, the competitive position of the European Union would suffer.")

[26] *See, e.g.*, Opinion of the European Economic and Social Committee on the Ethical and Social Dimension of European Financial Institutions, ¶ 1.1.7, OJ. No. C 100/84 (Apr. 30, 2009) ("The EESC is convinced that the grave financial crisis and the welcome defeat of casino capitalism could provide an opportunity to adopt more appropriate measures for safeguarding the financial system in the future while simultaneously relaunching the economy. A broad-based effort is required, commensurate with the danger that the virus detected in the financial sector might spread to the real economy as a whole.") *Cf.* Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817 (2006-7) discussing the Sarbanes-Oxley Act of 2002, which was enacted after the collapse of Enron and Worldcom. See also, *id.* at 1829 ("A palpable theme in much of SOX is discomfort with those over-heated incentives and insistence on more public accountability, so that large business corporations meet standards resembling those commonly expected of public and quasi-public institutions.")

[27] *Cf.* CESR, Public Statement, The 18th meeting of the Market Participants Consultative Panel, jointly with CESR members, (Feb. 9, 2009) *available at* http://www.cesr.eu/popup2.php?id=5560 ("Several members noted that governments have a tendency to act locally, whereas regulators try to act and coordinate globally.") CESR, the Committee of European Securities Regulators, was established by Commission Decision 2001/527/EC of 6 June 2001 establishing the Committee of European Securities Regulators, OJ No. L 191/43 (Jul. 13, 2001).CESR should "serve as an independent body for reflection, debate and advice for the Commission in the securities field". *Id*. at Recital no. 8. It also has a role in encouraging implementation of EU securities measures. CESR is composed of representatives of securities regulators from the Member States. See also Commission Decision of 23 January 2009 Establishing the Committee of European Securities Regulators, O.J. No. L 25/18 (Jan. 29, 2009) (repealing and substituting for Decision 2001/527/EC).

[28] SIFMA's comments cited *supra* note 25 illustrate a concern that market conditions may produce excessively onerous regulation.

to market protection rhetoric. CRAs' lobbying strategies have evolved as discussions about the broader future of financial regulation have evolved, and they have conceded a greater role for regulation in 2009 than they had before the crisis, but they continue to insist that the core of their methodological approaches to rating should be unregulated.[29]

CRA REGULATORY ISSUES

Credit rating agencies analyze the credit risk inherent in financial instruments, such as bonds, issued by various types of issuer. Credit risk is the risk that a borrower or an issuer of securities will fail to make payments of interest or principal at the specified time.[30] In analyzing credit risk, the CRAs take account of a range of public and private information about the issuer of the securities and the market in which it operates.[31] Different CRAs use different processes and models, some of which are proprietary, to develop the ratings they assign.[32] CRAs have developed criteria for rating structured products, and assign ratings after examining characteristics of the product structure to ensure that they conform to the CRA's criteria.[33] The CRAs' publications

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[29] And note that some commentators express reservations about how effectively rating agencies are addressing the problems. *See* House of Commons, Treasury Committee, Banking Crisis: Reforming Corporate Governance and Pay in the City, the Ninth Report of 2008-09, 4-5 (HC 519) (May 15, 2009) ("We remain deeply concerned by the conflict of interests faced by credit rating agencies, and have seen little evidence of the industry tackling this problem with any sense of urgency.")

[30] *See, e.g.*, IOSCO, Report on the Activities of Credit Rating Agencies, Report of the Technical Committee of IOSCO, 3 (Sept. 2003) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf (IOSCO 2003 report) ("A credit rating is an assessment of how likely an issuer is to make timely payments on a financial obligation. Where investors believe uncertainty or broad information asymmetries exist, they typically insist on being compensated for the risks they take. This compensation — which, for fixed-income securities, usually translates into higher interest rates — increases the cost of capital for issuers of such securities.)

[31] *See, e.g.*, *id.* at 3.

[32] *See, e.g.*, *id.* at 4.

[33] For a critique of the adequacy of the ratings process, *see, e.g.*, Kenneth C. Kettering, *Securitization and its Discontents: the Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1563 (2008) ("The rating agencies have a financial incentive to be relatively aggressive in their judgments about uncertain legal issues on which a widely-usable financial product depends. That aggressiveness is evident as to securitization, for the ratings issued in securitization transactions reflect a

have emphasized how seriously they approached these tasks,[34] and the reliability of their end-product, the ratings.[35] Although CRAs sometimes suggest that the ratings should not be relied on in certain circumstances,[36] they do not tend to state that their ratings are generally unreliable. On the other hand, while CRAs publicly state that their ratings are "information,"[37] on which they encourage investors to rely, in their interactions with regulators CRAs tend to argue that ratings are opinions rather than facts.[38] And while CRAs presented their actions with respect to structured products as neutral evaluations of the products, they have been actively involved in helping to

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higher confidence about favorable resolution of the legal issues than is warranted by the legal opinions customarily delivered to the rating agencies in such transactions. The principal constraints on aggressive ratings - risk of liability and desire to preserve reputational capital - are weak as applied to judgments about uncertain legal issues on which a widely-usable financial product depends. The light touch of regulation imposed by Congress on the rating agencies in 2006 does not directly alter the rating agencies' incentive to "round up" legal uncertainties that underpin a widely-usable product."). Professor Kettering suggests that the CRAs have placed undue reliance on formalities rarhger than on the substance of securitized transactions they have rated. *Id.* at 1628.

[34] *See, e.g.*, Standard and Poor's, Guide to S&P Structured Product Ratings, 5 (Jun. 2006) *available at* http://www2.standardandpoors.com/spf/pdf/funds/GuideStctdProdRtgs_20Jun06.pdf (A central component of our rating process is face-to-face meetings with arrangers and underlying managers. We look at the whole picture—the people, the processes, and operational due diligence—to come up with opinions and ratings that give investors and advisors greater confidence in their investment decisions.")

[35] *See, e.g.*, *id.* at 2 ("Standard & Poor's ratings are designed to provide investors with the information they need to be confident about their investment decisions.")

[36] *See, e.g.*, *id.* at 5 ("Standard & Poor's does not conduct surveillance on these products after the initial offer period expires, so our rating cannot be relied upon beyond this period. For example, beyond the initial period, they should not be used as a basis for making a decision to trade the product in a secondary market.")

[37] *Supra* note 35.

[38] *See, e.g.*, Standard & Poor's Ratings Services, Toward a Global Regulatory Framework for Credit Ratings (Mar. 2009) *available at* http://www2.standardandpoors.com/spf/pdf/media/GlobalRegReport.pdf ("Investors also use rating opinions as a tool in making investment decisions — although it is important for investors to realize that ratings are only one tool, and they should not be used as a substitute for independent investment analysis.")(S&P White Paper). *Cf.* Eugene Volokh, Testimony for the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing on Approaches to Improving Credit Rating Agency Regulation, 7 (May 19, 2009) *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/volokh.pdf ("A rating agency's bare prediction about a company's creditworthiness, captured in the rating itself, will likely be seen as pure opinion.")

design the structures that they would then rate.[39] The claim that CRAs are effectively providing information to the public, much as newspapers and other publishers do, serves, in the US, to align them with other entities whose speech is protected under the first amendment.[40] In the EU, while there tends to be less litigation with respect to financial activity,[41] there is also not a real equivalent to the first amendment to the US Constitution.

Regulators, legislators and commentators have identified a range of issues with respect to CRAs during the market crisis.[42] Some of these issues are external to the CRAs and relate to the over-reliance of investors and regulators on ratings.[43] Investors

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[39] And ratings of securitized structures have been carried out in ways that are inconsistent with CRAs' ratings of corporates. *See, e.g.*, Kettering, *supra* note 33, at 1573 ("When analyzing the creditworthiness of an Originator, credit analysts at the predominant rating agencies steadfastly recognize that the Originator's securitized debt is economically equivalent to secured debt incurred by the Originator. Yet their colleagues at the same rating agencies who rate the securitized debt itself do so on the blithe assumption that it is quite different from secured debt incurred by the Originator.")

[40] For a discussion, *see, e.g.*, Volokh, *supra* note 38. *Cf.* S 1073, A bill to provide for credit rating reforms, and for other purposes, introduced by Senator Jack Reed on May 19, 2009 (providing for circumstances under which investors might sue CRAs.)

[41] *See, e.g.*, Samuel Issacharoff & Geoffrey P. Miller, *Will Aggregate Litigation Come to Europe?*, 62 VAND. L. REV. 179 (2009); Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England*,1998 COLUM. BUS. L. REV. 51.

[42] *See, generally, e.g.*, Committee on the Global Financial System, Ratings in Structured Finance: What Went Wrong and What Can Be Done to Address Shortcomings? CGFS Papers No 32 (Jul. 2008) *available at* www.bis.org/publ/cgfs32.pdf. Users of ratings have responded to this issue also. *See, e.g.*, European Fund and Asset Management Association, European Securitisation Forum & Investment Management Association, Asset Management Industry Guidelines to Address Over-Reliance upon Ratings (Dec. 11, 2008) *available at* http://www.efama.org/index.php?option=com_docman&task=doc_download&gid=834&Itemid=-99.

[43] Enhancing Resilience, *supra* note 1, at 37-9. *See also, e.g.*, FSF Follow-up, *supra* note 22, at 14 (noting that IOSCO was working on the issue of investors' reliance on ratings). *See also id.* at 22, (noting that "The SIFMA, the ESF and the CMSA are developing securitisation investor credit assessment principles to support investors in developing well articulated investment processes and independently assessing the risks associated with a transaction.") *Cf.* ESF, ICMA, ISDA, LIBA, SIFMA, Structured Products: Principles for Managing the Distributor-Individual Investor Relationship, 4 *available at* http://www.sifma.org/private_client/pdf/GlobalRSP-Distributor-PrinciplesFinal.pdf ("Credit ratings of issuers or, where applicable, guarantors, may not represent a rating of the potential investment performance of the individual structured product itself. Credit ratings, however, should be taken into account to the extent that it affects the terms of the product. If credit ratings are provided, the related disclosure should make clear the significance of the rating. Distributors should use credit ratings accordingly.")

have relied on ratings as indicators of more than the credit risk that the CRAs claim to assess. And the FSA has suggested that the inclusion of ratings changes in contracts as triggers of events of default may be counterproductive.[44] Other issues are internal to the CRAs. In April 2008, the Financial Stability Forum wrote that:

> The sources of concerns about CRAs' performance included: weaknesses in rating models and methodologies; inadequate due diligence of the quality of the collateral pools underlying rated securities; insufficient transparency about the assumptions, criteria and methodologies used in rating structured products; insufficient information provision about the meaning and risk characteristics of structured finance ratings; and insufficient attention to conflicts of interest in the rating process.[45]

These sources of concern about CRAs had been evident for some time before 2008. For example, the risk that conflicts of interest might have a negative impact on ratings was one of the concerns that led to the enactment of the Credit Rating Agency Reform Act of 2006 in the US,[46] and to IOSCO's work on CRAs.[47] The concern about

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[44] FSA, a Regulatory Response to the Global Banking Crisis, 19, Discussion Paper DP 09/2 (Mar. 2009) *available at* http://www.fsa.gov.uk/pubs/discussion/dp09_02.pdf ("The use of ratings 'triggers' in financial products and contracts may, if ratings change rapidly, present significant challenges to a firm in managing its risks and obligations. It is essential that firms take full account of the existence of such triggers in their stress testing and contingency funding plans. Equally, the FSA will work with the investor community to raise awareness that the inclusion of such triggers in contract documentation, while intended to protect their interests, may perversely undermine them by precipitating the rapid collapse of the entire firm. This is another area in which action by individual entities can have significant system-wide consequences. As such it is a further example of the type of issue that will need to be tracked as part of macro-prudential surveillance.")

[45] Enhancing Resilience, *supra* note 1, at 8. The FSF stated that among the issues to be addressed was "The usefulness and transparency of credit ratings. Despite their central role in the OTD model, CRAs did not adequately review the data input underlying securitised transactions. This hindered investors in applying market discipline in the OTD model." *Id.* at 10. *Cf.* The High Level Group on Financial Supervision in the EU, Report, 9 (Feb. 25, 2009) *available at* http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (The de Larosière Report) ("The major underestimation by CRAs of the credit default risks of instruments collateralised by subprime mortgages resulted largely from flaws in their rating methodologies.")

[46] *Cf.* GAO Report, *supra* note 9, at 31 ("until 2006, no legislation had established statutory regulatory authority or disclosure requirements over credit rating agencies.53 Then, to improve the quality of ratings in response to events such as the failures of Enron and Worldcom—which highlighted the limitations of credit ratings in identifying companies' financial strength—Congress passed the Credit Rating Agency Reform Act of 2006, which established limited SEC oversight, requiring their registration

conflicts of interest grew out of the CRAs' funding model, because the issuer of securities tends to pay for the ratings which the CRAs supply.[48] This structural feature of the market for ratings creates a conflict of interest for CRAs: they typically have an economic incentive to set favorable ratings so as to attract and retain business.

Some CRAs have developed business models where the issuer does not pay for the ratings.[49] Recent regulatory actions tend to distinguish between issuer-paid and non-issuer paid ratings on the basis that they involve different issues for regulation.

Regulation of CRAs has tended to focused on managing conflicts of interest, although, despite attempts to control conflicts of interest, the SEC noted that there were issues with respect to CRAs' management of conflicts of interest in a 2008 study.[50] The Financial Stability Forum has suggested that conflicts of interest may be a more acute problem in the context of ratings of structured products than in other contexts because of the detailed conversations about structuring which take place between the issuer and the CRA.[51]

Another general issue of concern with respect to CRAs relates to their ratings models. This was another area of historic concern, but in 2006 the US Congress specifically directed the SEC not to specify required characteristics of ratings models in

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and certain recordkeeping and reporting requirements" (footnotes omitted)).

[47] *See, e.g.*, IOSCO 2003 Report, *supra* note 30, at 2.

[48] *See, e.g.*, *id.* at 32 ("One issue that has received attention is whether CRAs' poor ratings performance in structured products might have reflected more intense conflicts of interest in the rating of these than for other products. The CRAs that rate the vast majority of such products rely primarily on an issuer-pays model and the revenues from this rating activity accounted for a fast growing income stream for these CRAs in recent years.") White notes that ratings were originally purchased by investors but suggests that the CRAs changed their funding model in response to the development of the photocopier. White, *supra* note 11, at 49.

[49] *See, e.g.*, text at note 83.

[50] SEC Study, *supra* note 10, at 2.

[51] Enhancing Resilience, *supra* note 1, at 33 ("To the extent that CRAs discuss with issuers during this structuring process the rating implications of particular structures, the potential for conflicts of interest becomes greater.")

regulating CRAs.[52] In 2008, the SEC's study of CRAs[53] and the FSF[54] identified issues with the models CRAs used to establish ratings for structured products.[55] The CGFS suggested that CRAs had been insufficiently sensitive to the differences between rating corporate bonds and structured investments.[56] And the FSF noted that the CRAs' models for rating securities backed by sub-prime loans failed accurately to deal with the lack of historical data on default rates for sub-prime loans.[57] The FSF emphasized that CRAs should exercise due diligence with respect to the data they use in their models to generate ratings.[58]

Although regulators have been reluctant to specify the processes CRAs use to generate ratings, they have been more willing to contemplate requiring that CRAs disclose characteristics of their ratings models. In 2003, one of the issues IOSCO's technical committee investigated with respect to CRAs related to the amount of

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[52] *See supra* note 13.

[53] SEC Study, *supra* note 10.

[54] Enhancing Resilience, *supra* note 1, at 32 ("CRAs assigned high ratings to complex structured subprime debt based on inadequate historical data and in some cases flawed models.")

[55] *Cf.* European Savings Bank Group, ESBG Response to IOSCO Consultation on Credit Rating Agencies (Apr. 29 2008) available at http://www.esbg.eu/uploadedFiles/Position_papers/ESBG%20comments%20to%20IOSCO%20consultation%20on%20CRAs.pdf ("ESBG Members are concerned that the models used for structured finance products by CRAs have failed and therefore, we see the necessity for an analysis of the possibility of supervising CRAs' models.")

[56] *See, e.g.*, CGFS, *supra* note 42, at 4-7.

[57] Enhancing Resilience, *supra* note 1, at 33 ("The severe underestimation by CRAs of the credit risks of instruments collateralised by subprime mortgages resulted in part from flaws in their rating methodologies. One issue was the limited set of historical data available for subprime lending activities, which increased the model risk in the rating process. In particular, historical data on the performance of US subprime loans were largely confined to a benign economic environment with rising house prices. The lack of sufficient historical data or of scenario analysis that adequately assessed how particular asset pools would respond to potential economic scenarios led to ratings mistakes. In particular, CRAs underestimated the correlations in the defaults that would occur during a broad market downturn.").

[58] Enhancing Resilience, *supra* note 1, at 37, IOSCO, Report of the Technical Committee, Code of Conduct Fundamentals for Credit Rating Agencies, (May 2008) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf (IOSCO Revised Code of Conduct).

disclosure CRAs made about their ratings criteria and decisions.[59] The SEC's 2008 study of CRAs also focused on this issue.[60] The FSF has stated that investors should be given more information about the assumptions underlying structured product ratings and be warned about the limitations of the ratings.[61]

Many observers have expressed concern that there is insufficient competition in the market for ratings. The FSF has linked the issue of disclosure about ratings with the issue of competition, saying that CRAs should improve their disclosures about the performance of their ratings in order to increase competition in the ratings market.[62] CRAs have been more receptive to the idea of increasing competition in the ratings market than they have been to the idea of regulation of ratings models.[63]

As the CRAs may have under-emphasized the distinctions between structured product ratings and bond ratings, so did investors. The FSF suggests that CRAs must signal that structured product ratings are different from corporate bond ratings.[64] In May 2008, IOSCO's revisions to its Code of Conduct for CRAs suggested that CRAs should distinguish ratings for structured products from other ratings.[65]

It is clear that, although policy-makers seek to emphasize that the more recent CRA regulatory issues relate to structured products, many of the sources of unreliability of ratings which observers noted in 2008 were essentially the same problems that regulators had previously identified. The mechanisms which had been introduced to fix these problems failed. Thus current discussions of how to regulate CRAs appear to be taking place in the shadow of an earlier regulatory failure.

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[59] IOSCO 2003 Report, *supra* note 30, at 2.

[60] SEC Study, *supra* note 10, at 13.

[61] Enhancing Resilience, *supra* note 1, at 35-6; IOSCO Revised Code of Conduct, *supra* note 58, at [].

[62] Enhancing Resilience, *supra* note 1, at 33.

[63] *See, e.g.*, S&P White Paper, *supra* note 38, at 5.

[64] Enhancing Resilience, *supra* note 1, at 34-5.

[65] IOSCO, Revised Code of Conduct, *supra* note 58, at.

Part of the current difficulty associated with ratings of structured securities products may be the complexity of, and variation in, the documentation for different securities products. Standardization of documentation could address these issues.[66]

Another aspect of the problems relates to the idea that investors and regulators relied inappropriately on the work of CRAs. Regulators encouraged or required investors to rely on credit ratings in making investment decisions. And regulators encouraged financial institutions to use credit ratings in making their capital adequacy calculations.[67] This official recognition of credit ratings lent credibility to CRAs and arguably magnified the effects of any problems associated with their ratings models.

CRAS AND TRANSNATIONAL "SELF- REGULATION"

Over the period since 2003, IOSCO has been involved in developing supranational standards for the regulation of CRAs, from its initial Report on CRAS,[68]

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[66] *See, e.g.*, Gert Wehinger, Lessons from the Financial Market Turmoil: Challenges ahead for the Financial Industry and Policy Makers, 95 Financial Market Trends 29 (OECD 2008/2) *available at* http://www.oecd.org/dataoecd/47/25/41942918.pdf ("An important step towards more transparency in the structured products area would be standardisation of documentation and of products. While this may come at the expense of variety – it may nonetheless better allow issuers and investors to fine-tune their risk exposures – a limited number of contract types would help to enhance their transparency and increase their tradability. As markets in these products may become more liquid, price discovery and the building of pricing infrastructures (including trading platforms, data gathering, indices etc.) would be facilitated."). Cf. Caroline Bradley, *Private International Law-Making for the Financial Markets*, 29 FORDHAM INT'L L. J. 127 (2005) (discussing standardized documentation as a type of private regulation).

[67] *Cf.* Investment Management Association, Public Comment on Code of Conduct Fundamentals for Credit Rating Agencies (Nov. 8, 2004) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD177_32.pdf ("The IMA urges that securities regulators do not bring CRAs into their regulatory oversight or supervision. As noted above, ratings are merely opinions and there will be a range of opinions in the wider market about any borrower or bond. That leads to healthy markets. There is a real danger of investors being misled as to the quality of a rating if there appears to be some formal regulatory "endorsement" of the CRA.")

[68] *See supra* note 30.

and Statement of Principles,[69] to consultation on[70] and the development of Fundamentals of a CRA Code of Conduct.[71] After the Code of Conduct Fundamentals were finalized, and CRAs developed their own Codes of Conduct, IOSCO conducted a limited review of implementation of the Fundamentals.[72] In May 2008, IOSCO updated the Fundamentals.[73]

IOSCO has emphasized self-regulation by CRAs, but its approach to developing principles and fundamentals for the regulation of CRAs has involved regulators and the CRAs themselves. The initial consultation document on fundamentals for CRA Codes of Conduct noted that it had been developed with input from CRAs.[74] However, at the same time, IOSCO is an organization of securities commissions and it also sought initial input from the Basel Committee of Banking Supervisors, and the International Association of Insurance Supervisors.[75] IOSCO described its objectives as follows:

the CRA Code Fundamentals are not designed to be rigid or formulistic.

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[69] IOSCO, Statement of Principles Regarding the Activities of Credit Rating Agencies, Statement of the Technical Committee of IOSCO (Sept. 2003) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf.

[70] IOSCO, Code Of Conduct Fundamentals For Credit Rating Agencies, Consultation Report from the Technical Committee Chairmen Task Force on CRAs (Oct. 2004) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD173.pdf.

[71] IOSCO, Code of Conduct Fundamentals for Credit Rating Agencies, Report of the Technical Committee of IOSCO (Dec. 2004) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf..

[72] IOSCO, Review Of Implementation Of The IOSCO Fundamentals Of A Code Of Conduct For Credit Rating Agencies, Report of the Technical Committee of IOSCO, 5 (Feb. 2007) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD233.pdf ("Because IOSCO as an organization does not have the resources or legal authority to conduct a full assessment of whether CRAs have implemented the IOSCO CRA Code in ways that they have publicly stated they have, the Technical Committee instead is focusing on the most basic and essential aspect of implementation: whether a given CRA has, in fact, adopted a code of conduct and the degree to which this code of conduct is coherent with the provisions of the IOSCO CRA Code.") See also Comments Received on the Consultation Report, Review of Implementation of the IOSCO Fundamentals of a Code of Conduct for Credit Rating Agencies (May 2007) *available a*t http://www.iosco.org/library/pubdocs/pdf/IOSCOPD249.pdf.

[73] *See supra* note 58.

[74] *See* IOSCO Consultation Report, *supra* note 70, at i.

[75] *Id.*

> They are designed to offer CRAs a degree of flexibility in how these measures are incorporated into the individual codes of conduct of the CRAs themselves, according to each CRA's specific legal and market circumstances. However, in developing their own codes of conduct, CRAs should keep in mind that securities regulators may decide to incorporate the CRA Code Fundamentals into their own regulatory oversight, may decide to supervise compliance with the CRA Code Fundamentals, and/or may decide to provide for an outside arbitration body to enforce the CRA Code Fundamentals.[76]

In the Consultation Report IOSCO asked for public comment on its proposals,[77] and it reported on the public comments it received.[78]

Although the IOSCO Code of Conduct Fundamentals were the result of a process which involved regulators and CRAs, the Fundamentals were not in any formal sense binding on CRAs unless they were reflected in domestic legislation or regulations, and it is this formally non-binding character which gives rise to the characterization of the Fundamentals as a self-regulatory mechanism.[79] Although CRAs did not generate the Fundamentals themselves, they did suggest that the Fundamentals would help them by improving the credibility of the industry,[80] and

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[76] *Id.* at 2.

[77] The consultation was an early example of IOSCO consulting publicly on its work. *See, e.g.*, International Securities Market Association, International Primary Market Association, Danish Securities Dealers Association, London Investment Banking Association, Swedish Securities Dealers Association, Public comments on IOSCO's Consultation Report on Code of Conduct Fundamentals for Credit Rating Agencies *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD177_25.pdf. In 2005, IOSCO formalized its approach to consultation. *See* IOSCO Consultation Policy And Procedure, Report of the Executive Committee of IOSCO (Apr. 2005) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD197.pdf.

[78] Public Comments on Code of Conduct Fundamentals for CRAs (Nov. 2004) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD177.pdf.

[79] I critique the concept of a self in self regulation in Caroline Bradley, *The Self in Self-Regulation*, *available at* [].

[80] Austin Rating, Comments on the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (Nov. 8, 2004) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD177_4.pdf ("We

responded by developing Codes of Conduct to reflect the Fundamentals.[81] At the same time, CRAs emphasized that IOSCO's principles should not constrain CRAs in their choice of methodology and practices, and should not restrict competition.[82] For example, Rapid Ratings noted that its funding model differed from the issuer pays model for ratings:

> Business Model Type 2: New generation rating agencies are paid by third parties (banks, insurance companies, investment funds, pension funds, large creditors etc) to rate second parties (listed and/or unlisted companies). Type 2 rating agencies typically use software rather than analysts. Thus, in the Type 2 Model, there may be no contact between the rating agency and the companies it rates and no potential for conflict of interest. In such a case, it would be unfair to require a Type 2 company to conform to criteria that pertain only to Type 1 companies.[83]

Dominion Bond Rating Services argued that the Fundamentals should be seen as "aspirational" rather than being made legally binding on CRAs.[84] IOSCO has stated that ensuring flexibility and competition are important components of the IOSCO Code for CRAs.[85]

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believe that the Code will contribute to enhance the credibility and integrity of the rating industry.")

[81] *See, e.g.*, Fitch Ratings, Code of Conduct, (Apr. 2005) *available at* http://www.fitchratings.com/web_content/credit_policy/code_of_conduct.pdf. The Introduction to this Code of Conduct states: "Throughout its history, Fitch has established and implemented policies, procedures and internal controls to ensure the objectivity and integrity of its ratings. Fitch's Code of Conduct... summarizes Fitch's existing policies and procedures designed to ensure the highest standards for Fitch's ratings." *Id.* at 3.

[82] *See, e.g.*, Comments of Austin Rating, *supra* note 80; Dominion Bond Rating Service Ltd., Public Comment on Code of Conduct Fundamentals for Credit Rating Agencies (Nov. 5, 2004) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD177_39.pdf ("We believe that the Consultation Report might interfere with the legitimate business practices of existing CRAs, and could erect unnecessary barriers to new CRAs' entry into this field.")

[83] Rapid Ratings, Comments on the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (Nov. 8, 2004) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD177_1.pdf.

[84] DBRS Comments, supra note 82.

[85] IOSCO, Review of Implementation, *supra* note 72, at 6.

In the US and the EU, policy makers decided — at different points in time — that they needed to move beyond self-regulation of CRAs. The following sections of the paper describe some of the recent relevant regulatory proposals and actions in the EU and the US.

CHANGING REGULATION OF CRAS

The regulation of CRAs involves three sets of interconnected issues: first, how to ensure the accuracy of ratings; second, how to ensure that conflicts of interest do not distort credit ratings, and third, how to ensure that investors do not over-rely on ratings.

1. CRA REGULATION IN THE EU

Whereas the US introduced a new statutory regime for CRAs in 2006,[86] in the period between Enron and the market turmoil beginning in 2007, the EU did not propose harmonized regulation of CRAs until 2008.[87] In 2006 the EU Commission issued a Communication on the regulation of CRAs[88] which identified some existing EU measures which could affect the legal position of CRAs. These were measures to control market abuse and insider trading,[89] and the EU's capital adequacy rules which provided for the use of credit assessments by recognised External Credit Assessment Institutions.[90] The Commission also noted the possible relevance of regulation of the

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[86] *See supra* note 13.

[87] *See supra* note 8.

[88] Communication from the Commission on Credit Rating Agencies, O.J. No. C 59/2 (Mar. 11, 2006) *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:059:0002:0006:EN:PDF.

[89] *See id.* at 3-4.

[90] *See, e.g.*, CRA Communication, supra note 88, at 5 ("The CRD sets out a number of requirements which ECAIs should meet before the competent authority grant them recognition. For example, their ratings must be objectively and independently assigned and reviewed on an ongoing basis. In addition, their rating procedures should be sufficiently transparent. In addition, the competent authorities should assess whether individual credit assessments are recognised in the market as credible and reliable by the users of such credit assessments and accessible at equivalent terms to all interested parties.")

provision of investment advice under MiFID and of EU competition law.[91] The Commission concluded that as of 2006 no new EU rules were necessary, in part because of IOSCO's initiatives.[92]

In 2008 the financial market crisis politicized financial regulation in the EU, and, after some encouragement by the EU Member States acting through the Council,[93] the Commission revisited the regulation of CRAs.[94] The Commission began by publishing consultation documents.[95] Some commentators on the proposals expressed concerns about whether the proposals were consistent with better regulation principles, with regulation in other jurisdictions and with the powers of CESR,[96] and about whether increased regulation might encourage, rather than discourage, over-reliance on

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[91] *See id.* at 5.

[92] *See id.* at 6 ("It is encouraging that many credit rating agencies have established their own Codes of Conduct based on the IOSCO Code. But establishing these Codes in itself is not enough; they must also be implemented in practice on a day to day basis. The Commission intends to ask CESR to monitor compliance with the IOSCO Code and to report back to it on an annual basis. It will also consider how best to gauge the opinions of market participants, especially those purchasing complex financial instruments. This might include the setting up of an informal expert group. The ratings industry should be aware that the Commission may have to take legislative action if it becomes clear that compliance with EU rules or the Code is unsatisfactory and damaging EU capital markets.")

[93] Council of the European Union, Press Release, 2822nd Council Meeting, Economic and Financial Affairs, Luxembourg (Oct. 9, 2007) 13571/07 (Presse 217) *available at* http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/96375.pdf.

[94] The Commission carried out consultations before acting, itself and through CESR and ESME. Proposed CRA Regulation, supra note 8, at 5.

[95] *See* EU Commission Working Document, Proposal for a Regulatory Framework for CRAs (Jul. 31, 2008) *available at* http://ec.europa.eu/internal_market/consultations/docs/securities_agencies/consultation-cra-framework_en.pdf ; EU Commission Working Document, Policy Options to Address the Problem of Excessive Reliance on Ratings (Jul. 31, 2008) *available at* http://ec.europa.eu/internal_market/consultations/docs/securities_agencies/consultation-overreliance_en.pdf .

[96] CESR is the Committee of European Securities Regulators, which co-ordinates the work of European securities regulators and advises the EU Commission on the implementation of EU measures. It is not a regulatory body as such. The De Larosière Report, supra note 6, at 46-58 suggests a revision of the structure for financial regulation in the EU, with the development of a European System of Financial Supervision. In this new structure, CESR (or its successor body) would have the responsibility for licensing CRAs in the EU and monitoring their performance. *Id.* at 19.

ratings.[97] In November 2008, the EU Commission formally proposed a Regulation for European CRAs[98] in the light of the deficiencies of the self-regulatory model:

> Self-regulation based on voluntary compliance with the IOSCO code does not appear to offer an adequate, reliable solution to the structural deficiencies of the business. While the industry has come up with several schemes for self-regulation, most of these have not been robust and or stringent enough to cope with the severe problems and restore the confidence in the markets. Moreover, individual approaches by some of the credit rating agencies would not have the market-wide effect necessary to establish a level playing field across the EU and preferably worldwide.[99]

The Commission also expressed reservations about the substance of IOSCO's model. The rules were "abstract and generic" and there was no enforcement mechanism.[100] But the Commission noted that as the ratings business was a global business it was important for the EU's rules to be similar to those in the US.[101] The Commission chose to propose legislation to set up a registration and surveillance framework for CRAs rather than less intrusive, and non-binding, regulatory solutions such as maintaining the

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[97] *See, e.g.*, Joint response by HM Treasury, the Financial Services Authority (FSA) and the Bank of England to the Commission Consultation (Sept. 5, 2008); Response by the Swedish Ministry of Finance to the Commission's consultation on Credit Rating Agencies (Sept. 5, 2008). These responses are available from http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies&vm=detailed&sb=Title .

[98] The Commission proposed a Regulation rather than a Directive in part because there was no comprehensive regulation of CRAs in the Member States and in part in the interests of speed because Regulations are not transposed into the legal systems of the Member States by domestic implementing measures. Proposed CRA Regulation, supra note 8, at 7.

[99] Proposed CRA Regulation, supra note 8, at 3. Cf. The Institute for International Finance, Comments on the Draft Directive/ Regulation of the European Parliament and of the Council on Credit Rating Agencies (Sept. 5, 2008) (arguing for the establishment of an SRO for CRAs).

[100] Proposed CRA Regulation, supra note 8, at 3.

[101] *Id.* ("Given the global nature of the rating business, it is important to level the playing field between the EU and the US by setting up a regulatory framework in the EU comparable to that applied in the US and based on the same principles.")

existing self-regulatory approach, drafting a European Code of Conduct or a Commission recommendation,[102] in part in order to provide "an efficient counterbalance to other important jurisdictions, notably the US".[103]

The Proposed CRA Regulation would require registration for "credit rating agencies whose credit ratings are intended to be used for regulatory purpose by financial institutions to comply with Community legislation".[104] In order for UCITS established in the EU to rely on ratings, or for financial firms regulated under MiFID to execute trades in instruments which are rated, the ratings will need to be provided by CRAs registered in the EU.[105]

CESR is to be a "one-stop-shop for applications and a central point for informing and coordinating all EU national regulators."[106] This would be a new role for CESR, and something of a move in the direction of an EU-level regulator, and registration is to be effective on publication in the EU's Official Journal,[107] although ongoing supervision would be a matter for the competent authority where a CRA had its registered office.[108]

As a matter of substance, the proposed Regulation would require CRAs to be independent and avoid conflicts of interest.[109] In order to ensure independence the

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[102] The Commission noted the relevance of Better Regulation principles, but concluded that a legislative solution would satisfy the need for effectiveness and certainty better than non-legislative solutions. *Id.* at 5.

[103] *Id.* at 5.

[104] Proposed CRA Regulation, supra note 8, at 9, and Arts 12-17 at 23-27.

[105] Proposed CRA Regulation, supra note 8, Art. 4, at 20.

[106] *Id.* The Explanatory Memorandum also states: "To function as a single entry point, CESR should be closely involved in the registration process from the outset and be entitled to give its advice on the granting or withdrawal of the registration by the competent authority of the home Member Stated and may request reexamination of draft decisions (Article 17)." *Id.*

[107] *Id.*

[108] Proposed CRA Regulation, supra note 8, at 9.

[109] Proposed CRA Regulation, supra note 8, Art. 5, at 20.

proposed Regulation mandates governance requirements for CRAs.[110] And the proposed Regulation addresses conflicts of interest in part by restricting the activities in which CRAs are allowed to engage.[111] Thus, rather than merely ensuring transparency as to the governance and business model of a CRA, the proposed Regulation seeks to require certain fundamental conditions for governance and CRA business models.

The proposed Regulation would also regulate CRAs' relationships with their employees,[112] for example, requiring CRAs to ensure that their employees have appropriate knowledge and experience, that employees who are directly involved in the rating process do not negotiate fees for ratings and that employees' compensation is not dependent on the revenue they produce. CRAs with more than fifty employees are to ensure rotation of employee raters.

With respect to methodology, the Proposed CRA Regulation explicitly requires disclosure rather than regulating ratings methodology.[113] Article 7 does require the CRA to take account of "all information available to it that is of relevance according to its rating methodologies" and to ensure the information it uses is "of sufficient quality and from reliable sources", and Annex I requires CRAs to review their methodologies and models. But the recitals to the proposed regulation (which are not operative parts of the measure even when adopted but which may be used in interpreting the measure) suggest a rather different view:

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[110] Proposed CRA Regulation, supra note 8, Annex I, at 35-6. For example, "The administrative or supervisory board of a credit rating agency shall include at least three non-executive members who shall be are independent. The remuneration of the independent members of administrative or supervisory board shall not be linked to the business performance of the credit rating agency and shall be arranged so as to ensure the independence of their judgement. The term of office of the independent members of the administrative or supervisory board shall be for a preagreed fixed period not exceeding five years and shall not be renewable. The dismissal of independent members of the administrative or supervisory board shall only take place in case of misconduct or professional underperformance." *Id.* at 35.

[111] Proposed CRA Regulation, supra note 8, Annex I, at 36-7. For example, "A credit rating agency shall not provide consultancy or advisory services to the rated entity or any related third party regarding the corporate or legal structure, assets, liabilities or activities of the rated entity or any related third party." *Id.* at 37.

[112] Proposed CRA Regulation, supra note 8, Art. 6, at 20-21.

[113] See Proposed CRA Regulation, supra note 8, Art. 7, at 21-22.

> Credit rating agencies should use rating methodologies that are rigorous, systematic, and continuous and result in ratings that may be subject to validation based on historical experience. Credit rating agencies should ensure that methodologies, models and key rating assumptions used for determining credit ratings are properly maintained, up-to-date and subject to a comprehensive review on a periodic basis. In cases where the lack of reliable data or the complexity of the structure of a new type, in particular structured finance instruments, raises serious questions as to whether the credit rating agency can produce a credible credit rating, the credit rating agency should refrain from issuing a credit rating or withdraw an existing credit rating.[114]

Thus the EU's proposed CRA Regulation mandated certain required components of a CRA's business model and also contained provisions of some ambiguity with respect to ratings methodology, leading to uncertainty. The proposal did not attempt to minimize reliance on ratings, nor, despite the rhetoric,[115] did it seem to be designed to encourage much effective competition for ratings.[116]

In April 2009 the European Parliament approved the proposal subject to amendments which take account of many of the comments of the industry on the proposed regulation.[117] For example, in answer to concerns about conflicts between the EU rules and those in other jurisdictions, the EP's resolution states that EU based and

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[114] Proposed CRA Regulation, supra note 8, Recital 14, at 13.

[115] *See, e.g.*, Proposed CRA Regulation, supra note 8, at 2 ("The current crisis has revealed weaknesses in the methods and models used by credit rating agencies. One reason may be that credit rating agencies operate in an oligopolistic market that offers limited incentives to compete on the quality of the ratings produced.")

[116] *Cf.* Karel Lannoo, Credit Rating Agencies, Scapegoat or free-riders? ECMI Commentary No. 20/9 (Oct. 2008) *available at* http://shop.ceps.eu/downfree.php?item_id=1733. This article relates to the earlier version of the proposal.

[117] European Parliament Legislative Resolution of 23 April 2009 on the Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies, P6_TA-PROV(2009)0279, *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2009-0279&language=EN&ring=A6-2009-0191.

regulated CRAs should be able to endorse ratings produced by non EU regulated CRAs which are developed in accordance with requirements as stringent as those in the proposed regulation.[118] Responding to concerns about the possible extensive reach of the proposed regulation, the EP's resolution provides that "Investment research, investment recommendations, and other opinions about a value or a price for a financial instrument or a financial obligation should not be deemed to be credit ratings". And, with respect to CRA methodologies, the resolution provides:

> Credit rating agencies should use rating methodologies that are rigorous, systematic, continuous and subject to validation including by appropriate historical experience and back-testing. However, this requirement should in no case provide grounds for interference with the content of credit ratings and methodologies by competent authorities and Member States.

The EP showed a practical concern for encouraging competition in the ratings business, for example by stating that smaller CRAs could be exempted from some of the requirements of the regulation.[119] Although the Parliament moderated the provisions of the Commission's proposal, it announced that it had approved new strict rules for CRAs,[120] and news stories accepted this characterisation.[121]

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[118] *See id.*, revised proposal Article 4a.The Commission would determine whether the rules of a non-EU country were equivalent to those in the EU.

[119] EP resolution, supra note 117("In order to take account of specific conditions of credit rating agencies employing fewer than 50 employees, the competent authorities should be able to exempt such credit rating agencies from some of the obligations laid down by this Regulation as regards the role of the independent members of the board, the compliance function and the rotation mechanism, and in so far as those credit rating agencies are able to demonstrate that they comply with specific conditions. The competent authorities should examine, in particular, whether the size of the credit rating agency has been determined in such a way as to avoid compliance with the requirements of this Regulation by a credit rating agency or by a group of credit rating agencies. The application of the exemption by competent authorities of Member States should be made in such a way as to avoid the risks of fragmenting the internal market and to guarantee the uniform application of Community law.")

[120] European Parliament, Press Release, Credit Rating Agencies: Partially Responsible for the Current Financial Crisis Say MEPs (Apr. 23, 2009) *available at* http://www.europarl.europa.eu/pdfs/news/expert/infopress/20090422IPR54187/20090422IPR54187_en.pdf .

[121] *See, e.g.*, Andrew Willis, EU Gets Tough on Credit-Rating Agencies, Business Week (Apr. 24, 2009) *available at* http://www.businessweek.com/globalbiz/content/apr2009/gb20090424_056975.htm .

2. NRSRO REGULATION IN THE US

Whereas the EU Commission's proposal for a CRA Regulation has an inherent cross-border operation, the SEC's regulation of CRAs is primarily a matter of domestic regulation. The SEC acts as an administrative agency exercising delegated powers under legislation, rather than creating a legal framework which, if adopted, will bind sovereign states. Also in contrast to the EU's proposed CRA Regulation, the SEC's recent regulations amend an existing regulatory regime for CRAs under an existing statutory scheme,[122] rather than attempting to create a new regulatory regime.

The SEC's regulations for NRSROs deal with potential conflicts of interest rather differently from the EU Commission's proposals. The SEC's rules identify a range of circumstances which might give rise to conflicts of interest. Some conflicts of interest are prohibited,[123] but others are prohibited unless the NRSRO has disclosed them to the SEC and has written policies and procedures to manage conflicts of interest.[124] There seems to be more flexibility in the SEC's approach than in the EU's proposed rules. In the adopting release, the SEC stated:

> The Commission believes that these prohibitions are appropriate in the public interest and for the protection of investors because they are designed to ensure that users of credit ratings are made aware of the potential conflicts of interest that arise from an NRSRO's business activities and that an NRSRO establishes policies and procedures for managing the specific conflicts it identifies.[125]

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[122] In the US, the SEC regulates nationally recognized statistical rating organizations or NRSROs. *See* Sec. & Exch. Comm'n, Credit Rating Agency Reform Act of 2006; Implementation— Nationally Recognized Statistical Rating Organizations, 72 Fed. Reg. 33564 (Jun. 18, 2007) (NRSRO 2007 Adopting Release); 17 CFR § 240.17g-1 to 17g-6.

[123] For example, NRSROs are prohibited from providing a rating where the NRSRO, a credit analyst who worked on determining a credit rating, "or a person responsible for approving the credit rating, directly owns securities of, or has any other direct ownership interest in, the person that is subject to the credit rating." 17 CFR § 240.17g-5(c)(2).

[124] 17 CFR § 240.17g-5.

[125] NRSRO Adopting Release, supra note 122, at 33595. The SEC recognized that certain conflicts were common in NRSROs and decided that they should be managed rather than prohibited: "Prohibiting these types of conflicts outright may adversely impact the ability of an NRSRO to operate as a

Whereas the EU Commission has proposed to define governance requirements for EU-regulated CRAs, NRSROs regulated by the SEC seem to have more flexibility as to how they manage conflicts of interest through their governance arrangements.[126]

In early 2009 the SEC adopted new rules for NRSROs. Many of the new rules relate to disclosures NRSROs must make about their activities, and to record-keeping. However, the SEC has also added some new prohibited activities as a way of addressing issues of conflicting interests. These now include issuing a rating on a security the NRSRO or an affiliate helped to structure,[127] and allowing an employee who works on ratings from participating in fee discussions,[128] or accepting any gift valued at $25 or more from companies, underwriters or sponsors.[129] These rules are similar to some of the rules which have been proposed by the EU Commission for CRAs, although there are some differences. For example, the EU's proposed ban on gifts does not include a monetary amount, but is expressed as a complete ban. Some commentators on the SEC's proposals had suggested that a ban on gifts might cause problems for NRSROs dealing with foreign issuers from some countries,[130] but it seems

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credit rating agency. Nonetheless, the conflicts must be managed through policies and procedures and disclosed so that users of the credit ratings can assess whether the conflict impacts the NRSRO's judgment." *Id.*

[126] The statute merely states that "Each nationally recognized statistical rating organization shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such nationally recognized statistical rating organization and affiliated persons and affiliated companies thereof, to address and manage any conflicts of interest that can arise from such business." 15 U.S.C. § 78o–7(h).

[127] NRSRO 2009 Adopting Release, supra note 17, at 6465-6. *See id.* at 6466 ("In simple terms, the rule prohibits an NRSRO from rating its own work or the work of an affiliate.") The rule is not meant to make the ratings process opaque, but to limit conversations between an NRSRO and structurers of structured products which would result in the NRSRO effectively rating its own work.

[128] NRSRO 2009 Adopting Release, supra note 17, at 6467.

[129] NRSRO 2009 Adopting Release, supra note 17, at 6468.

[130] See NRSRO 2009 Adopting Release, supra note 17, at 6468 ("Several NRSROs noted the potential for cultural misunderstandings over the proposed gift limit, noting that issuers from other countries may be embarrassed or offended by the prohibition. One NRSRO suggested in response that the Commission include an exemption or higher dollar threshold for gifts from foreign issuers, while another cited such potential misunderstandings in support of its suggestion that the conflict be disclosed

that the EU is preparing to deal with gifts more aggressively than the SEC. On the other hand, the SEC's new rules prohibit the conflicts and activities they regulate rather than allowing NRSROs to manage the conflicts through their own procedures.

In its new rules, the SEC requires enhanced disclosure with respect to CRA methodologies and ratings, in particular with respect to structured products.[131] The SEC had proposed that NRSROs be required to make disclosures about verification of assets underlying structured products, about whether assessments of the quality of originators were taken into account, and about how frequently ratings were reviewed,[132] and these requirements were adopted as part of the final rules.[133]

Under the new rules, NRSROs must disclose information about a random sample of issuer-paid ratings with a six-month delay. The requirement is drafted to ensure increased disclosure with respect to issuer-paid ratings while protecting the ability of NRSROs to derive revenues from ratings.[134] The original proposed rule would have applied to subscriber-paid as well as issuer-paid ratings and the SEC is seeking further comment on this proposal.[135] NRSROs are to disclose publicly and on their websites "in XBRL format and on a six-month delay, ratings action histories for a randomly selected sample of 10% of the outstanding credit ratings for each rating class

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and managed instead of prohibited. The Commission recognizes that a prohibition may pose initial difficulties with certain foreign issuers but believes that over time, and given the uniformity of the rule across NRSROs, such issuers will come to understand and accept the prohibition.")

[131] NRSRO 2009 Adopting Release, supra note 17, at 6457.

[132] NRSRO 2009 Adopting Release, supra note 17, at 6459.

[133] The requirement to disclose frequency of review of ratings applies to all ratings, whereas the first two requirements apply only to ratings of structured products. *Id.* at 6460.

[134] NRSRO 2009 Adopting Release, supra note 17, at 6461.

[135] NRSRO 2009 Adopting Release, supra note 17, at 6461 ("The Commission wants to carefully balance the commercial and competitive concerns expressed by NRSROs that determine subscriber-paid credit ratings with the Commission's objective of fostering accountability and comparability among all NRSROs. Therefore, in that release, the Commission asks detailed questions about the potential impact of applying the rule to subscriber-paid credit ratings. The responses to those questions will inform the Commission's deliberations as to whether this rule ultimately should be expanded to cover subscriber-paid credit ratings."). *See also* Sec. & Exch. Comm'n, Re-Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6485 (Feb. 9, 2009).

for which the NRSRO has issued 500 or more ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated."[136] Some commentators had suggested that the burden imposed by the requirement to publish the information in XBRL format was excessive, but the Commission responded:

> The Commission believes, however, that the XBRL format will benefit market participants seeking to develop their own performance statistics using the ratings history data to be made public by the NRSROs. Requiring NRSROs to make histories of ratings actions for issuer-paid credit ratings publicly available using the interactive data format rather than using other machine readable format will enable market participants, academics and others to analyze this information more quickly, more accurately, and at a lower cost. The Commission believes that this will enhance the ability of end-users to compare the rating performance of different NRSROs, which will foster NRSRO competition.[137]

The SEC had proposed that NRSROs should disclose information about default statistics for rated issuers, but this requirement does not appear in the current set of new rules because commentators raised numerous issues including concerns with respect to the practical ability of NRSROs to comply with the proposed requirement, and doubts as to the agency's authority to adopt such a rule.[138] The Commission conceded that there might be practical compliance issues but did not comment on the issue of authority to adopt such a rule.[139]

The Credit Rating Agency Reform Act provides that the SEC may not regulate "the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings" and commentators on the SEC's original proposal rules argued that a number of the

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[136] NRSRO 2009 Adopting Release, supra note 17, at 6462.

[137] *Id.*

[138] NRSRO 2009 Adopting Release, supra note 17, at 6458.

[139] *Id.*

proposed rules fell outside the scope of the SEC's authority because of this provision.[140] For example, the SEC proposed, and ultimately adopted (with modifications), a rule requiring NRSROs "to make a record documenting the rationale when a final credit rating materially deviates from the rating implied by a quantitative model used in the rating process if the model was a substantial component of the rating process."[141] Commentators on the proposed rule argued that it could have an impact on the substance of ratings and could encourage overemphasis of quantitative ratings models.[142] The Commission responded to these comments by narrowing the application of the rule so that it would only apply to structured product ratings and by emphasizing that the rule was adopted in the exercise of the SEC's authority to regulate record-keeping.[143] And the SEC also pointed out that NRSROs themselves would determine when a model was a substantial component of the rating process as well as what constitutes a material difference between the result produced by a model and the eventual rating.[144]

The US rules regulating disclosure and transparency with respect to ratings and the methodologies and practices which produce them are more detailed than those which the EU Commission has so far produced. In part this is probably because the SEC is already building on rules it adopted in 2007 to regulate NRSROs, which were themselves based on a 2006 statute, and the EU Commission is only just beginning to try to regulate CRAs through formal legislative instruments. The EU's proposal does provide for the Commission to amend parts of the Regulation after it is adopted.

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[140] *See, e.g.*, Moody's Investors Service, Comments on Proposed Rules for Nationally Recognized Statistical Rating Organizations (Release No. 34-57967; File No. S7-13-08) ("Proposing Release") (Jul. 28, 2008) *available at* http://www.sec.gov/comments/s7-13-08/s71308-52.pdf; Standard & Poor's , Comments on Proposed Rules for Nationally Recognized Statistical Rating Organizations, Securities Exchange Act of 1934 Release No. 57967 (June 16, 2008) File No. S7-13-08, (Jul. 24, 2008) *available at* http://www.sec.gov/comments/s7-13-08/s71308-23.pdf.

[141] NRSRO 2009 Adopting Release, supra note 17, at 6463.

[142] *Id.*

[143] *Id.*

[144] *Id.*

RHETORIC AND REALITY IN THE REGULATION OF CRAS

As a rhetorical matter, two arguments have been consistently made by CRAs and industry groups about how CRAs should be regulated. And these arguments have also been accepted by transnational standard setters. First, regulation should not interfere with the CRA's methodologies and business models[145] (market protection rhetoric) and second, regulation should take account of the global nature of the CRA business[146] (harmonization rhetoric). In March 2009 Standard and Poor's published a White Paper which makes both arguments.[147] The White Paper states that "regulators must protect analytical independence by avoiding rules and examination processes that impact the substance of rating opinions and an agency's analytics,"[148] and

> "Regulators in any country should take care before seeking to exceed existing standards given the effect such an approach could have on rating agencies operating in multiple jurisdictions. These agencies may face conflicting rules that could ultimately harm ratings consistency due to country- or region-specific requirements."[149]

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[145] *See, e.g.*, Fitch Ratings, Comments on CSA Consultation Paper 11-405, CSA Proposal No 1: The CRA Framework (Dec. 19, 2008) *available at* http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part1/Comments/11-405/com_20081219_11-405_rajs.pdf ("We strongly believe that the cornerstone of any regulatory approach with respect to CRAs should be an acceptance by the regulator that its supervision should not, in any way, intrude, or appear to intrude, into the actual substance of opinions determined by the CRAs or the content or choice of rating methodology. Regulation should concern oversight of the processes used to assign ratings.") *Cf.* IOSCO Consultation Report, supra note 70, at 2 ("Like the IOSCO CRA Principles, the objectives of which are reflected herein, the CRA Code Fundamentals are also intended to be useful to all types of CRAs relying on a variety of different business models. The CRA Code Fundamentals do not indicate a preference for one business model over another, nor are the measures described therein designed to be used only by CRAs with large staffs and compliance functions.")

[146] FSF Follow-up, *supra* note 22 at 6 ("To preserve a level playing field and maintain open and integrated financial markets, it is important that authorities avoid a fragmented approach in implementing the recommendations, including on oversight of CRAs, accounting and valuation standards, supervisory and regulatory standards, and supervisory oversight of banks' risk management practices.")

[147] S&P White Paper, *supra* note 38.

[148] *Id.* at 5.

[149] *Id. See also, e.g.*, House of Commons Treasury Committee, supra note 29, at 75 ("All of the CRAs and many of the other submissions we received called upon the authorities to ensure that global consistency in regulation was achieved.")

The first of these arguments is problematic, because it is difficult to make neat distinctions between the ratings models, which CRAs argue should not be regulated, and conflicts of interest, which are classic matters for regulation in financial firms. As the Turner Review said:

> there are concerns about whether the governance of rating agencies has adequately addressed issues relating to conflict of interest and analytical independence. Rating agencies competing for the business of rating innovative new structures may not have ensured that commercial objectives did not influence judgements on whether the instruments were capable of being rated effectively. And the practice of making the models by which agencies rated structured credits transparent to the issuing investment banks also created the danger that issuers were 'structuring to rating' i.e. designing specific features of the structure so that it would just meet a certain rating hurdle. [150]

Although CRAs have made some concessions recently, accepting that they will be more strictly regulated in future, they continue to maintain that there is a distinction between conflicts of interest,[151] which can be regulated and ratings methodologies, which cannot.[152]

As to the second argument, this paper illustrates that the approaches of the EU Commission and of the SEC to the regulation of CRAs are not entirely consistent - even the terminology used to refer to the regulated entities is different. And in some ways, in arguing for harmonization, CRAs may end up getting rather more than they hope for if their harmonization rhetoric is used by the official sector to achieve more detailed and

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[150] Turner Review, *supra* note 6, at 78.

[151] Consider here the Kettering point about CRAs' (mis?)characterizations of legal rules and their implications for securitizations. Note 33.

[152] *See, e.g.*, Deven Sharma, Executive Comment: Reevaluating And Rebuilding A More Useful Ratings System, (Mar. 13, 2009) *available at* http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/4,5,5,1,1204844895664.html ("regulators should focus on overseeing ratings firms' policies and standards for managing potential conflicts of interest. Ratings opinions and methodologies, however, should be free from regulatory interference.")

restrictive regulation, rather than to limit the costs of compliance.[153] The Standard and Poor's White Paper of March 2009 already seems to make more concessions to concerns of policy makers than some of the firm's earlier statements about CRA regulation.[154] It is not clear how meaningful this shift is: it may be merely a reflection of the different audiences to which the two documents are addressed - the earlier, a technical lawyers' response to an agency's proposed rulemaking, and the latter a more publicly visible, more political document designed to fend off new legislative initiatives.

[In this section I propose to develop the discussion of problems with these two arguments in the current context. For example, as CRAs have pointed out, their businesses often seem to be organized in ways which outsiders perceive to involve conflicts of interest. Moodys argued that the SEC's proposal to prohibit employees who were involved in negotiating fees from being involved in generating ratings was "impractical and undesirable".[155]]

CONCLUSIONS

The aim of this paper is to track the development of the use of market protection rhetoric and harmonization rhetoric by CRAs and other financial market participants from the post-Enron period to the current moment. Like other participants in the financial markets, CRAs assumed before the recent crisis that they could continue to hold regulators at bay by arguing for limited intervention by regulators in self-regulating market activity. Since the crisis the problem of financial regulation has moved beyond

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[153] Although note that the private sector has been participating actively in developing solutions to some of the visible regulatory problems *See, e.g.*, FSF Follow-up, *supra* note 22 at 7 ("The FSF welcomes the initiatives by private sector bodies – such as the Counterparty Risk Management Policy Group (CRMPG III), the Institute of International Finance (IIF), the member bodies of the Securities Industry and Financial Markets Association (SIFMA) and ISDA – that identify lessons from recent events and recommend best industry practices. These proposals are consistent with and complementary to the FSF efforts. Collective action of market participants is now needed to ensure rigorous implementation.")

[154] *See, e.g.*, Standard & Poor's Comments, *supra* note 140.

[155] Comments of Moody's Investors Service, supra note 140, at 15 ("As we discuss in more detail below, we recommend that the Commission adopt a rule that... recognizes that it is impracticable and undesirable to expect NRSROs to completely separate analytic functions from the function of determining and discussing fees with issuers and subscribers).

technocratic fora to the political arena in which such arguments have less traction. The result has been that even some regulators who used to speak favorably of better regulation and limited intervention in the markets[156] have begun to talk of a need for more effective regulation.[157] The CRAs have adapted their rhetorical strategies to the new regulatory environment with some success. In the US and the EU so far policy-makers have accepted that there are limits to the extent to which they should interfere with CRAs' choices about methodology. But the rule-making contexts where politics matter most tend to be domestic rather than supranational contexts, and consumer-voters now seem to care about at least some aspects of financial regulation. We have not yet reached a stable transnational equilibrium in the regulation of CRAs.

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[156] *See, e.g.*, Turner Review, *supra* note 6 at 87 ("the FSA's regulatory and supervisory approach, before the current crisis, was based on a sometimes implicit but at times quite overt philosophy which believed that.. Markets are in general self correcting, with market discipline a more effective tool than regulation or supervisory oversight through which to ensure that firms' strategies are sound and risks contained.")

[157] *Id.* at 88.