A STEP SHORT OF CHANGE: EXAMINING THE RECENT REGULATION OF CREDIT RATING AGENCIES AND ITS SHORTCOMINGS IN A GLOBAL MARKET

Julia Zukina[*]

---

* Julia Zukina is a law student at Brooklyn Law School.

INTRODUCTION

In a post-2008 global economy, credit rating agencies have firmly grabbed the attention of regulators, who are currently in the process of revamping the regulatory framework of the financial markets and their corresponding participants. For years, if not decades, credit rating agencies have "wielded enormous quasi-governmental power" by issuing their assessments of the creditworthiness of debt and its respective issuer.[1] However, various regulatory agencies, such as the United States Securities and Exchange Commission, the European Securities and Markets Authority, and the Securities and Exchange Board of India, have become increasingly cognizant of the pervasive and dangerous overreliance on credit ratings and the agencies that issue them. The recent financial crisis of 2008, as well as a number of recent credit rating scandals, has forced regulators to quickly respond with additional legislation and redoubled enforcement efforts.

This paper examines the recent regulatory efforts within the United States, the European Union, and emerging markets. The European Union is examined through the lens of the efforts of its member state, the United Kingdom, while regulatory efforts in India are explored as a case study of credit rating agencies in emerging markets. Part I is a brief synopsis of the history and functions of credit rating agencies which traces their evolution into a mainstay of the financial markets. Part II takes a closer look at one of the most influential credit rating agencies in the global economy: Standard & Poor's. Aside from being one of the largest credit rating agencies, Standard & Poor's was also recently involved in two of the largest American credit rating scandals, which are examined in detail here. The first was the collapse of the Enron Corporation in 2001. The second was the recent downgrade of the United States long-term sovereign debt during the summer of 2011.

Part III of this paper examines the recent regulation efforts of credit rating agencies in the United States. Specifically, it looks at the Credit Rating Agency Reform Act of 2006 and the Dodd–Frank Wall Street

1. Amy Borrus, *The Credit-Raters: How They Work and How They Might Work Better*, BUS. WK., Apr. 8, 2002, at 38-40, *available at* http://www.ba.metu.edu.tr/~adil/BA-web/bus%20press/credit%20raters.pdf.

Reform and Consumer Protection Act of 2010. Part IV examines corresponding regulatory legislation in the European Union, specifically the EU Regulation on Credit Rating Agencies adopted in 2009, as well as its 2011 Amendment. It also addresses the recent efforts spearheaded by its member state, the United Kingdom, in pushing further reform in the form of a second amendment to the EU Regulation. Part V discusses the role of credit rating agencies in India, as well as the regulatory actions taken by the Securities and Exchange Board of India. Part VI briefly discusses the corresponding work of the International Organization of Securities Commissions in the field of credit rating agency regulation. Finally, Part VII explores several changes that are necessary in order to effectively restructure the credit rating system and its regulation.

This paper argues that in order to successfully replace overreliance on credit ratings supplied by an oligopolistic market, a four-step process must be undertaken by regulators through a single, unified effort. First, regulators must establish increased accountability measures for rating mistakes, which would hold credit rating agencies responsible for their actions. Second, international standards of review and regulation of the agencies must be established and standardized in order to allow comparison between ratings and facilitate further measures of accountability. Third, regulators must make a concerted effort to extend mutual recognition to other regulatory frameworks in order to create a comprehensive and overlapping system of regulation and monitoring. Finally, regulators must pursue mandatory registration of all credit rating agencies under a standardized system of regulation that protects both credit rating agencies and other market participants. In addition, this paper explores the merits of provocative proposals to impose performance-based sanctions on the credit rating industry.

I. A BRIEF BACKGROUND ON CREDIT RATING AGENCIES

Credit rating agencies function by evaluating "the creditworthiness of corporate and sovereign issuers of debt securities."[2] According to the United States Securities and Exchange Commission (SEC), a credit rating agency ("CRA") is "a firm that provides its opinion on the creditworthiness of an entity and the financial obligations (such as, bonds, preferred stock, and commercial paper) issued by an entity."[3] Therefore, credit rating agencies "assess the ability of companies, institutions, and governments to service

2. Roberta S. Karmel, *IOSCO's Response to the Financial Crisis,* 37 J. CORP. L. 849, 867 (2012).

3. *Credit Rating Agencies–NRSROs*, U.S. SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/answers/nrsro.htm (last modified May 12, 2011).

their debts."[4] The evaluation comes in the form of a rating which represents the likelihood that a particular security will perform according to its terms, in the CRA's opinion.[5] The rating is typically a letter- and number-based assessment of the risk, which represents the "forward-looking opinion" of a particular CRA.[6] Although it is technically an opinion, the credit rating has gained considerable credibility over the years, particularly as a reference point for various regulatory frameworks.[7]

In the United States, John Moody published a manual rating 200 railroads and their securities in 1909 in order to provide information about the creditworthiness of the bonds.[8] The creation of Standard & Co., Poor's and Fitch followed in 1916 and the 1920s, respectively.[9] Soon afterward, the Comptroller of the Currency announced that American banking institutions would only be allowed to hold investment grade securities[10] in conjunction with the Banking Act of 1935,[11] cementing the role of credit rating agencies permanently.

Finally, in 1975, the SEC adopted the term "nationally recognized statistical rating organization" (NRSRO) while amending the broker–dealer regulation regarding capital adequacy under the Securities Act of 1934.[12] The Commission chose to recognize credit rating agencies such as Fitch, Moody's, and Standard & Poor's through no-action letters rather than passing a rule that formally defined the term "NRSRO."[13] Presently, there are ten firms registered as NRSROs with the SEC: A.M. Best Company, Inc., DBRS Ltd., Egan–Jones Rating Company, Fitch, Inc., Japan Credit Rating Agency, Ltd., Kroll Bond Rating Agency, Inc., Moody's Investors Service, Inc., Rating and Investment Information, Inc., Realpoint LLC, and Standard & Poor's Ratings Service.[14]

---

4. John Ryan, *The Negative Impact of Credit Rating Agencies and Proposals for Better Regulation* 6 (German Inst. for Int'l & Sec. Affairs, Working Paper FG1, 2012/No. 01, Jan. 2012).

5. *Id.*

6. Jason W. Parsont, *NRSRO Nullification: Why Ratings Reform May Be In Peril,* 77 Brook. L. Rev. 1015, 1021-22 (2012).

7. Karmel, *supra* note 2, at 867.

8. Borrus, *supra* note 1; *see also* Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis,* 63 U. MIAMI L. REV. 1111, 1116 (2009).

9. Borrus, *supra* note 1.

10. *Id.*

11. Dennis, *supra* note 8, at 1117.

12. Blair A. Nicholas & Ian D. Berg, *Credit Rating Agencies: Out of Control and In Need of Reform*, 15 NO. 4 ANDREWS SEC. LITIG. & REG. REP. 1 (June 30, 2009); *see also* Karmel, *supra* note 2, at 867-68.

13. Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1696 (2008); *see also* Karmel, *supra* note 2, at 868.

14. *Credit Rating Agencies–NRSROs*, *supra* note 3.

A. The Structure of Credit Rating Agencies

Credit rating agencies have generally operated under two types of business models: the subscription model and the issuer-pays model.[15] Under the subscription model, the credit rating agency provides financial product ratings to investors through a subscription service.[16] Since investors are the primary clients, the agency is incentivized to provide accurate credit ratings in order to retain its customers.[17] On the other hand, under the issuer-pays model, credit rating agencies sell their individual ratings directly to the issuers of financial products.[18] As the primary client, the issuer often utilizes the credit rating as a type of certification in order to facilitate the process of selling the financial products.[19] Some have argued that this type of model creates an incentive for the credit rating agency to produce a higher, or more optimistic, credit rating for the issuer–client, although this incentive may be balanced by the need to maintain credibility among investors.[20]

Originally, credit rating agencies favored a subscription model.[21] This preference ultimately shifted to an issuer-pays model, the change coinciding with increasing globalization and the introduction of new financial products that necessitated credit ratings.[22] In 1974, Standard & Poor's shifted to an issuer-pays model in favor of a subscription service, with the other agencies following closely behind.[23] The shift also coincided with several possibly related events such as the rise of low-cost photocopying, which facilitated the spread of information among investors,[24] a series of liquidity crises, and increased regulation of NRSROs by the SEC.[25] These events likely encouraged credit rating agencies to exclusively seek out issuer–clients who

15. Emily McClintock Ekins & Mark A. Calabria, *Regulation, Market Structure, and Role of the Credit Rating Agencies*, at 5 (Cato Inst. Policy Analysis No. 704, 2012), *available at* http://www.cato.org/publications/policy-analysis/regulation-market-structure-role-credit-rating-agencies.

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.* at 6.

22. *Id.* at 7.

23. *Id.*

24. *Id.* (citing Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis* (NYU Center for Law and Business Research, Working Paper No. 01-001, 2001); Lawrence J. White, *Good Intentions Gone Awry: A Policy Analysis of the SEC's Regulation of the Bond Rating Industry* 13-16 (NYU Law School, Working Paper No. 05-23, 2005)).

25. *Id.* at 7 (citing Lawrence J. White, *A New Law for the Bond Rating Industry*, Regulation, Spring 2007, at 48-50).

were dependent on ratings services, rather than continue to cater to investors who increasingly had access to other sources of financial information.

B. The Big Three

Although there are currently ten firms that are officially registered with the SEC as NRSROs, three firms control the vast majority of the global market: Fitch, Inc., Moody's Investors Service, Inc., and Standard & Poor's Ratings Service.[26] Together, the three firms issue 98% of all NRSRO ratings even though Fitch controls a significantly smaller market share in comparison to its Big Three counterparts.[27] Frank Partnoy argues that this type of oligopolistic market structure bestows "immense, quasi-governmental power" upon the Big Three, despite their adherence to a long list of regulatory requirements and guidelines.[28] With a dearth of real competitors, the Big Three are almost exclusively sought out by issuer–clients. This means that a majority of issuers rely on the same two or three ratings methodologies, replete with their own flaws and inconsistencies.

The oligopolistic landscape in the credit rating field has not changed for decades. One argument has been that the state of regulation by agencies such as the SEC has limited the entry of new actors, thereby promoting the Big Three oligopoly.[29] In addition, the oligopoly is likely perpetuated by "the need for a strong reputation in credit rating agencies: the three incumbent companies have existed longest, making it difficult for new companies . . . to enter the field."[30] Issuers consistently seek out brand-name recognition in an effort to channel trustworthiness to potential investors.

---

26. Frank Partnoy, Council of Institutional Investors, *Rethinking Regulation of* Credit Rating Agencies*: An Institutional Investor Perspective, 2* (2009), *available at* http://www.cii.org/special_reports.

27. *Id.*

28. *Id.*

29. Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis* (NYU Center for Law and Business Research, Working Paper No. 01-001, 2001); *see also* Ryan, *supra* note 4, at 15.

30. Ryan, *supra* note 4, at 15.

II. Taking a Closer Look at Standard & Poor's Ratings Service

A. A Brief Overview of the Company Structure

Standard & Poor's ("S&P") is a self-proclaimed "leading provider of financial market intelligence" and an "essential part of the world's financial infrastructure."[31] It has physical locations in twenty-three countries around the world, including the United States.[32] S&P credits its beginning to Henry Varnum Poor, "a proponent of the 'investor's right to know,'" and his 1860 publication of "History of Railroads and Canals of the United States."[33] Poor's Publishing House merged with Standard Statistics in 1941 to form Standard & Poor's.[34] Subsequently, McGraw-Hill Companies, Inc. acquired the firm in 1966.[35]

Today, the structure of the company is divided into three distinct units: Standard & Poor's Ratings Services, S&P Dow Jones Indices, and S&P Capital IQ.[36] On September 24, 2007, the SEC granted Standard & Poor's Ratings Services registration as an NRSRO under Section 15E of the Securities Exchange Act of 1934.[37]

B. The Involvement of Standard & Poor's in the Collapse of the Enron Corporation

The Enron Corporation was formed by Kenneth Lay in 1985, as the result of a merger of two natural gas pipeline companies.[38] It owned 37,000 miles of pipelines for transporting natural gas between producers and utilities.[39] Although it did consistently well throughout the 1990s, Enron stock suddenly increased by 56% in 1999, and again by 87% in 2000.[40] By the end of 2000, Enron's market capitalization exceeded $60 billion, which represented seventy times its earnings and six times its book value.[41] Just a

---

31. *Key Statistics,* Standard & Poor's, http://www.standardandpoors.com/about-sp/key-statistics/en/us (last visited Oct. 20, 2012).
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.*
37. Order Granting Registration of Standard & Poor's Ratings Services as a Nationally Recognized Statistical Rating Organization, Exchange Act Release No. 34-56513, 91 SEC Docket 1785 (Sept. 24, 2007).
38. Paul M. Healy and Krishna G. Palepu, *The Fall of Enron*, Vol. 17 No. 2 Journal of Econ. Perspectives 3, 5 (Spring 2003).
39. *Id.*
40. *Id.* at 2.
41. *Id.*

year later, on December 2, 2001, Enron filed for bankruptcy.[42] Despite the opening of an SEC inquiry, the restatement of financials for the previous four years, and a sudden merger agreement with Dynergy, the major credit rating agencies downgraded Enron's debt to junk bond status on November 28, 2001, only four days before its bankruptcy.[43]

A series of events beginning in the summer of 2001 gave indication that the company was undergoing some difficulty. On August 14, 2001, Jeff Skilling resigned as CEO for personal reasons and was replaced by Kenneth Lay.[44] Sometime in the second half of that month, Sherron Watkins, an Enron vice president, wrote an anonymous letter to Kenneth Lay expressing accounting concerns.[45] She also discussed the issue with a former colleague at the accounting firm Arthur Andersen who contacted the Enron audit team independently.[46] On October 12, 2001, an Arthur Andersen attorney contacted a senior partner in Houston to remind him not to retain documents that were no longer needed, prompting a vast amount of document shredding.[47] On October 16, Enron announced quarterly earnings and nonrecurring charges of $1.01 billion, which it claimed as asset write-downs for water and broadband businesses.[48]

Subsequently, on October 22, the SEC launched a potential conflict of interest inquiry regarding Enron, its directors, and its special partnerships.[49] Subsequently, on November 8, Enron restated its financials for the previous four years, reporting a $591 million decline in earnings and a $658 million increase in debt.[50] On the next day, Enron entered into a merger agreement with Dynergy, although the agreement collapsed following the downgrading of its stock to junk bond status by the major credit rating agencies on November 28.[51] Finally, the company filed for bankruptcy on December 2, 2001, less than a year after being named the most innovative large company in the United States by *Forbes* magazine.[52]

Appearing at a hearing before the Committee on Governmental Affairs in the Senate on March 20, 2002, Ronald M. Barone, a Managing Director in the Corporate and Government Ratings Group of S&P who dealt with the Enron account, stated that S&P now had information that had not been

---

42. *Id.* at 4.
43. *Id.*
44. *Id.* at 39.
45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.* at 15, 39.

available prior to Enron's bankruptcy.[53] S&P credited this failing directly to Enron, which "hid its true financial picture and, more specifically, its true creditworthiness from Standard & Poor's."[54] Critics noted that S&P waited to downgrade the company to junk bond status until after merger agreement negotiations failed rather than placing an emphasis on a $2.2 billion equity write-down.[55]

C. Standard & Poor's Recent Downgrade of the United States Credit Rating

In an unprecedented move, S&P lowered the long-term sovereign credit rating of the United States from "AAA" to "AA+" on August 5, 2011.[56] In its accompanying report, S&P stated that the action reflected its opinion that "the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in [its] view, would be necessary to stabilize the government's medium-term debt dynamics."[57] The agency specifically credited the general disagreement within Congress and the Administration with its increasingly pessimistic outlook.[58] S&P also threatened the possibility of a further downgrade to "AA" within the following two years.[59]

The following day, on August 6, 2011, the United States Department of the Treasury quickly responded to the announcement, issuing a statement that identified a mistake in S&P calculations.[60] In the release, the Department stated that S&P incorrectly calculated future deficit reduction according to the Budget Control Act, resulting in dramatically overstated

53. *Rating the Raters: Enron and the Credit Rating Agencies*, *Hearing Before the S. Comm. on Gov't Affairs*, 107th Cong. 8 (2002).

54. *Id.*

55. Borrus, *supra* note 1, at 2.

56. Nikola G. Swann, *United States of America Long-Term Rating Lowered to 'AA+' Due To Political Risks, Rising Debt Burden; Outlook Negative*, STANDARD & POOR'S (Aug. 6, 2011), http://www.standardandpoors.com/ratings/articles/en/ap/?assetID=1245316529563; *see also* Richard Adams, *US Stripped of AAA Credit Rating by S&P Over Political Weakness,* RICHARD ADAM'S BLOG: THE GUARDIAN (Aug. 5, 2011), http://www.guardian.co.uk/world/richard-adams-blog/2011/aug/06/us-credit-rating-downgrade-debt; Zachary A. Goldfarb, *S&P Downgrades U.S. Credit Rating for First Time,* WASH. POST (Aug. 5, 2011) (updated Aug. 6, 2011, 12:35 AM), http://www.washingtonpost.com/business/economy/sandp-considering-first-downgrade-of-us-credit-rating/2011/08/05/gIQAqKeIxI_story.html.

57. Swann, *supra* note 56.

58. *Id.*

59. *Id.*

60. John Bellows, *Just the Facts: S&P's $2 Trillion Mistake*, U.S. DEP'T OF THE TREASURY (Aug. 6, 2011), http://www.treasury.gov/connect/blog/Pages/Just-the-Facts-SPs-2-Trillion-Mistake.aspx.

deficits over the next ten years.[61] Despite conversations with the Department regarding the mistake and acknowledgement of the error, S&P decided to proceed with issuing a lowered credit rating.[62] The agency determined that the error was not significant enough to warrant a halt on issuing the credit downgrade,[63] which immediately garnered criticism for the mistake as well as the reasoning.[64] While some political analysts hailed S&P's decision to call out the widespread rancor and do-nothing attitude in Congress,[65] others quickly pointed out that S&P's recent failure in the 2008 financial crisis made it uniquely unqualified to issue political commentary regarding the fiscal consolidation plan.[66]

III. RECENT U.S. REGULATION OF CREDIT RATING AGENCIES

A. The Credit Rating Agency Reform Act of 2006

The United States Congress passed the Credit Rating Agency Reform Act (CRA Reform Act) in 2006.[67] The CRA Reform Act created a uniform registration procedure for a credit rating agency seeking recognition as a NRSRO under the jurisdiction of the SEC.[68] This included "substantive requirements on NRSROs with respect to misuse of non-public information, conflicts of interest, and anti-competitive or abusive conduct."[69] According to the Act, an NRSRO may be registered with the SEC in connection with up to five classes of credit ratings: "(1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities; and (5) issuers of government securities, municipal securities, or securities issued by a foreign government."[70]

The CRA Reform Act also implemented legislative definitions for key terms, including "credit rating," "credit rating agency," and "nationally

---

61. *Id.*
62. *Id.*
63. *Id.*
64. Joe Klein, *Standard & Poor's Downgrades Itself*, TIME (Aug. 6, 2011), http://swampland.time.com/2011/08/06/u-s-downgrades-standard-and-poors/.
65. Ezra Klein, *Standard & Poor's Has Been Wrong Before. But They're Right Now* [sic], WASH. POST (Aug. 6, 2011), http://www.washingtonpost.com/blogs/ezra-klein/post/standard-and-poors-has-been-wrong-before-but-theyre-right-now/2011/07/11/gIQANpnIyI_blog.html.
66. Paul Krugman, *S&P and the USA*, N.Y. TIMES (Aug. 5, 2011), http://krugman.blogs.nytimes.com/2011/08/05/sp-and-the-usa/.
67. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006).
68. 15 U.S.C. § 78o–7 (2006).
69. *Id.*
70. *Credit Rating Agencies–NRSROs*, *supra* note 3.

recognized statistical rating organization."[71] Finally, the Act amended the Securities Exchange Act of 1934 to make SEC recordkeeping and reporting requirements applicable to credit rating agencies registered as NRSROs.[72] This was an effort to extend the SEC's oversight powers over the credit rating agencies.

Following the passing of the CRA Reform Act, the SEC issued rules for implementing the Act in June 2007.[73] The corresponding rules elaborated on the registration requirements for NRSROs set forth in the Act.[74] In addition, they elaborated on the application of the recordkeeping and annual financial reporting rules to NRSROs[75] and required the establishment of procedures to avoid conflicts of interest and misuse of material nonpublic information.[76] Finally, the SEC rules enumerated prohibited acts and practices by NRSROs, generally "relating to tying the issuance or level of credit rating to an issuer's purchase of services or products in addition to the credit rating."[77]

Despite the promulgation of formal credit rating agency requirements under the CRA Reform Act and corresponding SEC rules, the regulation notably held back on two major opportunities with the potential to further check agency behavior. The regulations failed to provide the SEC with jurisdiction to regulate the substance of the credit rating itself.[78] Nor did the regulation allow the SEC to regulate the procedures and methodologies used by a credit rating agency to create a particular rating.[79] The Commission remains confined to investigation and enforcement based on perceived violations of the recordkeeping and reporting rules, as well as conflicts of interest and misuse of material nonpublic information by the credit rating agency. In addition, the CRA Reform Act did not create a private right of action against credit rating agencies.[80] Non-regulators such as investors remain without a forum to state a case of individual harm by the agencies.

---

71. Credit Rating Agency Reform Act of 2006, 15 U.S.C. § 78c(60)-(62) (2012).
72. *Id.* at § 78(q)(a)(1).
73. Application for Registration as a Nationally Recognized Statistical Rating Organization, 17 C.F.R. § 240.17g-1 (2007).
74. *Id.*
75. Records to be Made and Retained by Nationally Recognized Statistical Rating Organizations, 17 C.F.R. § 240.17g-2 (2012); Annual Financial Reports to be Furnished by Nationally Recognized Statistical Rating Organizations, 17 C.F.R. § 240.17g-3 (2012).
76. Conflicts of Interest, 17 C.F.R. § 240.17g-5 (2012); Prevention of Misuse of Material Nonpublic Information, 17 C.F.R. § 240.17g–4 (2012).
77. Karmel, *supra* note 2, at 870; *see also* 17 C.F.R. § 17g-6 (2007).
78. Karmel, *supra* note 2, at 870.
79. *Id.*
80. *Id.*

B. The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010

Eight years later, the United States Congress passed the Dodd-Frank Wall Street and Consumer Protection Act of 2010 ("Dodd–Frank") in an effort to increase the SEC's "regulatory responsibilities with respect to CRAs and [provide] for heightened transparency of rating methodologies in structured and non-structured financial products."[81] The Act created additional conflict of interest restrictions regarding credit rating agency boards, as well as conflicts in the context of sales and marketing structures.[82] Dodd–Frank also repealed the agencies' exemption from liability under Section 11 of the Securities Act of 1933.[83] However, this short-lived measure of real accountability was promptly waived by the SEC after the NRSRO-registered credit rating agencies simply refused to cooperate.[84]

Dodd–Frank also created the Office of Credit Ratings (OCR) at the SEC.[85] OCR is tasked with monitoring "the activities and conduct[ing] examinations of registered NRSROs to assess and promote compliance with statutory and Commission requirements."[86] Finally, in an effort to reduce their significance in the financial markets, the Act required "the removal of certain statutory references to credit ratings."[87] Over the years, regulators such as the Commission have increasingly relied on credit ratings to "provide a suitable disclosure framework for securities of differing risks."[88]

---

81. *Id.* at 871; *see also* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, Sec. 931-39H, 124 Stat. 1376 (2010).

82. 15 U.S.C. § 78o–7(c) (2006).

83. Dodd–Frank Act, sec. 939G.

84. Karmel, *supra* note 2, at 872. *See* Ford Motor Credit Co., SEC No-Action Letter, 2010 WL 2882538 (Nov. 23, 2010), *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm (stating that under 939G of the Dodd–Frank Act, credit rating agencies could be sued as "experts" for statements in prospectuses and registration statements; however, the NRSROs refused to be named as "experts," and the SEC was forced to waive this requirement); *see also* In re Lehman Bros. Mortgage-Backed Sec. Litig., 650 F.3d 167, 183 (2d. Cir. 2011) (citing 15 U.S.C. § 77k(a)(4) (any potential "expert" liability requires written consent provided by named experts along with registration statement, which the credit rating agencies did not provide)).

85. 15 U.S.C. § 78o–7(p)(1) (2010), *amended by* Dodd–Frank Act, sec. 932.

86. Office of Credit Ratings, U.S. SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/about/offices/ocr.shtml (last modified Jan. 23, 2013).

87. Karmel, *supra* note 2, at 872; *see also* Dodd–Frank Act, sec. 939A(b), § 78o–7 (requiring federal agencies "to remove any reference to or requirement of reliance on credit ratings and to substitute in such standards of credit-worthiness as each respective agency shall determine as appropriate for such regulations").

88. Ryan, *supra* note 4, at 7.

Unfortunately, this effort to establish alternative measures of creditworthiness has recently run into complications with Basel III.[89] In hearings in front of the House Financial Services Subcommittee on credit rating agencies, the Federal Reserve Board testified that the process of removing references to credit rating agencies according to Dodd–Frank's Section 939A was being complicated by Basel III, which still included such references.[90] As of September 2012, the implementation of Basel III in the United States remains at Stage 2, with only draft regulation published.[91] The Basel rulemakings are still in the process of being "coordinated with applicable work on implementation of the Dodd–Frank regulatory reform legislation,"[92] which includes the issue of credit rating references.

IV. THE REGULATION OF CREDIT RATING AGENCIES IN THE EUROPEAN UNION

A. EU Regulation on Credit Rating Agencies (CRA I Regulation)

In response to the contribution of the credit rating agencies to the recent global financial crisis, the European Union initially passed EU Regulation on Credit Rating Agencies ("CRA I Regulation") in September 2009.[93] CRA I Regulation "established rules of conduct to mitigate possible conflicts of interest and ensure high-quality and transparent ratings."[94] In addition, CRA I required credit rating agencies established in the European Union to seek authorization from the appropriate national authorities.[95] Conversely, the regulation required European Union entities to exclusively use ratings issued by credit rating agencies with EU authorization.[96] This

89. Basel III is a series of reform measures developed by the Basel Committee on Banking Supervision that are designed to "strengthen the regulation, supervision and risk management of the banking sector." *International regulatory framework for banks (Basel III)*, BANK FOR INTERNATIONAL SETTLEMENTS, http://www.bis.org/bcbs/basel3.htm (last visited Feb. 6, 2013). Previously, credit ratings were explicitly used as a benchmark by the Bank for International Settlements in Basel II to "calculate banks' regulatory risk capital." Ryan, supra note 4, at 7.

90. Jacqui Street, *US Regs: Basel III Conflicts with Dodd Frank,* GLOBAL FINANCIAL STRATEGY (July 27, 2011), http://www.gfsnews.com/article/2540/1/.

91. BANK FOR INT'L SETTLEMENTS, *Progress Report on Basel III Implementation*, 7 (Oct. 2012), *available at* http://www.bis.org/publ/bcbs232.pdf (last visited Mar. 5, 2013).

92. *Id.*

93. Commission Regulation 1060/2009, 2009 O.J. (L 302) 1, 2 (EC).

94. EUROPEAN COMMITTEE B, FINANCIAL SERVICES CREDIT RATING AGENCIES 2010-12, H.C. (Apr. 16, 2012 statement of Julie Elliott) (U.K.), *available at* http://www.publications.parliament.uk/pa/cm201012/cmgeneral/euro/120416/120416s01.htm.

95. Karmel, *supra* note 2, at 871.

96. *Id.*

was an effort to encourage registration by credit rating agencies who hoped to participate in the European markets.

CRA I stressed the need for independence requirements to avoid conflicts of interest, internal policies for the monitoring of ratings, and transparent disclosure measures.[97] The Regulation also required the use of ratings issued only by registered and certified credit rating agencies.[98] However, the CRA I Regulation continued to hold the view that individual countries within the European Union were capable of overseeing credit rating agencies through enforcement and supervision by their respective national regulators.[99]

B. May 2011 Amendment: Creation of ESMA

In May 2011, the European Union adopted amending regulation regarding credit rating agencies known collectively as CRA II.[100] CRA II "gave the European Securities and Markets Authority (ESMA) exclusive supervisory powers over CRAs registered in the EU."[101] Pursuant to this amendment, ESMA completely controls the registration process and regulation of credit rating agencies in the European Union.[102] The regulation also established independence and expertise requirements for members of credit rating agency boards.[103] Internal control mechanisms and conflict of interest restrictions, such as the prohibition of consultancy or advisory services for issuers presently undergoing the rating process, were also created under CRA II.[104]

Within the domain of exclusive control, ESMA is responsible for both the registration of credit rating agencies that operate within the European Union and for their ongoing supervision.[105] ESMA handles the imposition of fines and punishments, the submission of "draft regulatory technical standards (RTS) for endorsement by the European Commission," and the

---

97. *Id.* at 870. *See also* Commission Regulation 1060/2009, 2009 O.J. (L301) 1, 5-6 (EC), *available at* http://www.esma.europa.eu/system/files/L_302_1.pdf.

98. *Id.* at 871.

99. Jeremy Jennings-Mares, Tim Davies, & Susan Launi, *IFLR Structured Products and Derivatives Forum – Credit Ratings*, 3 (Feb. 3, 2011), *available at* http://www.mofo.com/files/Uploads/Images/IFLR-Structured-Products-and-Derivatives-Forum-Credit-Ratings.pdf.

100. Commission Regulation 513/2011, 2011 O.J. (L 145) (EU), *amending* Commission Regulation 1060/2009, 2009 O.J. (L 302) (EC).

101. EUROPEAN COMMITTEE B, *supra* note 94.

102. Karmel, *supra* note 2, at 873.

103. *Id.*

104. *Id.*

105. *ESMA's Report on the Supervision of Credit Rating Agencies,* EUROPEAN SECURITIES AND MARKETS AUTHORITY (Mar. 22, 2012), *available at* http://www.esma.europa.eu/system/files/2012-207.pdf.

assessment of third country regimes such as the recent mutual recognition of several sovereign regulatory frameworks discussed later in this paper.[106] Its enumerated powers include requesting relevant information, conducting hearings, examining records, and performing on-site inspections.[107] As of this year, there are 28 credit rating agencies currently registered with ESMA.[108]

Recently, ESMA has been able to resolve regulatory tensions with the United States by extending mutual recognition to the SEC regulatory framework.[109] Through the extension of mutual recognition, financial institutions in the European Union will be able to use credit ratings issued in the United States.[110] ESMA has also extended mutual recognition "to the regulatory framework for credit rating agencies . . . in Canada, Hong Kong and Singapore because all have a regulatory framework as 'stringent' as that in the EU."[111] This show of cooperation demonstrates ESMA's awareness of the international impact of credit ratings, as well as the need for a unified system of regulation for both credit rating agencies and the issuers who choose to employ their services.

C. Taking a Closer Look at the United Kingdom

Following the recent financial crisis, the United Kingdom's Financial Services Authority ("FSA") found that credit ratings "have become very deeply embedded in the regulatory architecture," with rating changes having a worldwide influence on the financial markets.[112] In particular, the Turner Report, published by the FSA in 2009, found that regulatory change was immediately necessary to address the "conduct of rating agencies and the management of conflict of interest."[113] Prior to the creation of ESMA as the sole regulatory body for credit rating agencies in the European Union, the United Kingdom had planned to designate the FSA for implementing a

---

106. *Id.*

107. *Id.*

108. *Id.*

109. Joe Kirwin, *Regulator Defuses EU-U.S. Dispute Over Credit Rating Agency Supervision,* 44 SEC. REG. & L. REP. NO. 12 (Mar. 19, 2012) (Bloomberg Law).

110. *Id.*

111. *Id.*

112. TREASURY SELECT COMMITTEE, BANKING CRISIS: REFORMING CORPORATE GOVERNANCE AND PAY IN THE CITY (May 12, 2009), H.C., ¶ 186 (U.K.), *available at* http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/51908.htm.

113. FINANCIAL SERVICES AUTHORITY, *The Turner Review: A Regulatory Response to the Global Banking Crisis*, 78 (Mar. 2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

regulatory framework for the firms.[114] However, as a member of the European Union,[115] the United Kingdom now falls under the scope of ESMA.[116]

1. *UK Parliament Spearheading the CRA III Reform*

The United Kingdom has continued to express concerns that governments place too much reliance on credit ratings despite recent regulation.[117] In re-examining the issue at the beginning of this year, Parliament stated that "current legislation does not address the possible risk of over-reliance on credit ratings by financial market participants."[118] Specifically, Parliament has expressed the sentiment that the CRA I and CRA II legislation has only established a floor for requirements regarding disclosure of methodologies, internal controls for credit rating agencies, and the general rating process.[119] In leading the call for CRA III reforms, Parliament would like "to increase transparency and to foster competition by reducing barriers to entry, rather than through interventionist measures."[120] This three-pronged approached is designed to counteract some of the flaws that remain in the European Union regulation of credit rating agencies, particularly the prevalence of several large firms with dominance over the market, much like the state of affairs in the United States.

Generally, current CRA III proposals suggest that an issuer that orders credit ratings from two or more credit rating agencies must "rotate one every three years at maximum . . . but may keep the second one for up to six."[121] Credit rating agencies such as Fitch have pointed out that issuers looking for credibility would continue to rely on the Big Three and swap them every six years, while swapping smaller credit rating agencies every three years.[122] From this perspective, forced swapping would only

---

114. Michelle McGagh, *FSA Assumes Remit will Expand After G20 Regulation Pledge,* CITYWIRE (Apr. 7, 2009), http://www.citywire.co.uk/new-model-adviser/fsa-assumes-remit-will-expand-after-g20-regulation-pledge/a335921.

115. *Countries*, EUROPA.EDU, http://europa.eu/about-eu/countries/index_en.htm (last visited Mar. 5, 2013).

116. *Credit Rating Agencies*, ESMA, http://www.esma.europa.eu/page/Credit-Rating-Agencies (last visited Mar. 5, 2013).

117. EUROPEAN COMMITTEE B, *supra* note 94.

118. *Id.*

119. *Id.*

120. *Id.*

121. Elly Hardwick, *CRA3: Winning Few Friends*, CREDIT BENCHMARK (Apr. 11, 2012, 6:34PM), http://creditbenchmark.org/cra3-winning-few-friends (on file with author).

122. *Id.* Threadneedle Investments, an international asset manager, has suggested that forced rotation will result in issuers swapping out credit rating agencies which give the lowest ratings. *See* Jonathan Pitkanen, *Credit Rating Agencies: Regulatory Reform in*

perpetuate the oligarchy of the major credit rating agencies rather than reform the market. ESMA itself has recently commented that new entrants, or smaller credit rating agencies, fighting the oligarchy of the market may be tempted to "compete by offering higher ratings or by lower prices."[123] From this perspective, mandatory rotation may actually result in a new series of problematic ratings and methodologies in direct opposition to the goals of the EU legislation.

In addition, CRA III seeks to impose civil liability on credit rating agencies.[124] Specifically, the civil liability would apply to a failure to adhere to ESMA regulations.[125] The CRA III liability is not designed to apply to ratings that prove to be incorrect or inaccurate.[126] Considering the "extent and complexity of the regulations, which are still not entirely finalised, it's hard to imagine that a disgruntled investor wouldn't be able to find some breach to exploit."[127] Furthermore, in a civil liability suit under CRA III, the burden of proof would lie with the credit rating agency to demonstrate that it did, in fact, adhere to ESMA regulations.[128] If implemented, this civil liability could perform the function of the failed Section 11 liability in the United States.

However, in the discussion of civil liability it is important to note that a lawsuit would be brought in a national court. This means that a country's reputation for its approach towards credit rating regulation may come into play in the near future if the regulation is adopted.[129] Ultimately, this provision may lead to forum shopping as investors seek to bring suits in nations that tend to take a hard stance against credit rating agencies while credit rating agencies push to have suits heard in national courts that are generally favorable to their positions. Under the CRA III proposal, member states are directed to enforce civil liability in cases of infringement that indicate intention or gross negligence.[130] However, ESMA itself has recently noted the difficulty in relying on the different procedural rules in effect in each of the enforcing EU Member States.[131] The interplay of "the possible

---

Europe, THREADNEEDLE INVESTMENTS (Apr. 2012), http://www.threadneedle.co.uk/media/1998862/en_viewpoint_credit_rating_agencies.pdf.

123. Verena Ross, Exec. Dir., European Sec. and Mkts. Auth., Speech at a public hearing in Brussels organized by the Committee on Economic and Monetary Affairs of the European Parliament: Credit Rating Agencies: What are the Next Steps? (Jan. 24, 2012), *available at* http://www.esma.europa.eu/system/files/2012-32_0.pdf.

124. Hardwick, *supra* note 121.

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

130. Ross, *supra* note 123.

131. *Id.*

interactions and inconsistencies among them" will be unpredictable in the near future if this portion of the CRA III proposal is implemented.[132]

V. THE REGULATION OF CREDIT RATING AGENCIES IN INDIA

A. The Securities and Exchange Board of India

The Securities and Exchange Board of India ("SEBI"), the national financial regulator, was established on April 12, 1992 under the Securities and Exchange Board of India Act of 1992.[133] According to the Act, SEBI was enacted "to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto."[134] The Board consists of eight permanent members that oversee its various departments.[135] The organizational structure includes specialized departments such as the Market Regulation Department and Investment Management Department, as well as Regional Offices.[136]

B. The SEBI (Credit Rating Agencies) Regulations

SEBI initially implemented the Securities and Exchange Board of India (Credit Rating Agencies) Regulations in 1999.[137] The 1999 regulations outlined the registration process for credit rating agencies, general obligations, and rating restrictions for certain parties with conflicts of interest, as well as procedures for inspection, investigation, and action in case of default.[138] Currently, there are six credit rating agencies registered with SEBI: CRISIL Limited, Fitch Ratings India Private Ltd., ICRA Limited, Credit Analysis & Research Ltd. (CARE), Brickwork Ratings India Private Limited, and SME Rating Agency of India Ltd. (SMERA).[139] CRISIL, the biggest agency, has a market value of over $1.3 billion, in comparison to a Western agency such as Moody's, which has a market

---

132. *Id.*
133. *About SEBI,* SECURITIES AND EXCHANGE BOARD OF INDIA, http://www.sebi.gov.in/sebiweb/stpages/about_sebi.jsp (last visited Mar. 5, 2013).
134. *Id.*
135. *Id.*
136. *Id.*
137. *Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999*, SEBI (Jul. 7, 1999), *available at* http://www.sebi.gov.in/acts/CreditRatingAgencies.pdf. Notably, this occurred prior to major Western regulation of credit rating agencies.
138. *Id.*
139. *Name and Registered Address of Credit Rating Agencies*, SEBI, http://www.sebi.gov.in/investor/addcra.html (last visited Mar. 5, 2013).

value of $8.9 billion.[140] All of the Indian credit rating agencies operate under the issuer-pays model, with issuers of debt paying for the credit ratings.[141]

C. Regulatory Actions Following the 2008 Financial Crisis

Following the global financial crisis, SEBI has tightened regulations on credit rating agencies.[142] Following the recommendations of a six-member committee set up by the Finance Ministry, SEBI has instituted additional disclosure requirements for credit rating agencies.[143] In particular, it has stated that an agency "will have to explain the factors underlying its ratings, provide a summary of discussions with an issuer's management, auditors and bankers, and reveal voting details of rating committee meetings along with notes of dissent."[144] Although this may have a chilling effect on ratings discussions, the goal is to improve transparency and avoid conflicts of interest in ratings assignments.[145]

SEBI has also directed credit rating agencies to "publish information about the historical default rates of rating categories,"[146] indicate unsolicited credit ratings, and ensure that its analysts remain separated from marketing and business development.[147] Finally, SEBI now requires CRAs to "disclose shareholding patterns, compensation arrangements with issuers, fees from rating services and non-rating services, issuer-wise share of non-rating income of the CRA, and names of issuers who contribute 10% or more of total revenue of the CRA."[148] Despite the tightening of regulation in response to the global financial crisis, credit rating agencies in India continue to enjoy a measure of trust and public approval arguably no longer afforded to Western credit rating agencies.[149]

---

140. *Letters from India*, ECONOMIST, Mar. 17, 2012, *available at* http://www.economist.com/node/21550282.

141. *Id.*

142. Anirudh Laskar, *Sebi Tightens Norms for Credit Rating Agencies*, LIVEMINT & THE WALL STREET JOURNAL (May 3, 2010, 7:30 PM), http://www.livemint.com/Politics/NtevI97zNxMU1K4EvQsmqO/Sebi-tightens-norms-for-credit-rating-agencies.html.

143. *Id.*

144. *Id.*

145. *Id.*

146. Laskar, *supra* note 142, ¶ 5. In response, Roopa Kudva, managing director and chief executive officer of credit rating agency titan CRISIL, said that "CRISIL is already compliant with all the suggested guidelines for managing conflicts of interest . . . [and it] will comply with additional disclosure requirements . . . stipulated by SEBI." *Id.* at ¶ 9.

147. Laskar, *supra* note 142, ¶ 10.

148. *Id.* ¶ 11.

149. *Letters from India*, *supra* note 140.

1. *Diversification of Business by the Agencies*

The credit rating agencies themselves attribute their success to a diversification of their business. [150] For example, most of the agencies have offered their services to smaller companies rather than exclusively focusing on growth through the rating of structured products.[151] CARE is interested in developing its consultancy business in favor of complete reliance on its ratings service.[152] Many of the other agencies have also diverted a significant stake of their resources to developing these alternative business strategies.[153]

2. *A Few Comments on the Optimistic Outlook of Indian Credit Rating Agencies*

The rosy outlook of Indian credit rating agencies must be taken with a grain of salt. Some have argued that the institutional hazards displayed by Western credit rating agencies have not had time to develop in the nascent Indian market.[154] Indian debt markets are still extremely small in comparison to their Western counterparts.[155] Notably, the rupee debt market remains "ring-fenced from the outside world."[156] On one hand, this may have prevented the spread of questionable ratings practices and conflicts of interest displayed by Western credit rating agencies.[157] However, it is possible that the small and isolated Indian market has not had a chance to cultivate the same institutional concerns displayed recently by the much older Western credit rating agencies.

In addition, three of India's biggest credit rating agencies, CRISIL, CARE and ICRA, were set up very recently: between 1988 and 1993.[158]

---

150. *Id.* ¶ 4-5.

151. *Id.* Credit rating agency ICRA is currently involved with rating local currency debt in Indonesia. Brickwork, a smaller credit rating agency, is exploring the option of offering quality ratings for institutions such as hospitals.

152. *Id.* CARE chief D.R. Dogra has stated that the agency continues to monitor potential conflicts of interest during the development of its consultancy branch.

153. *Id.* ICRA estimates that approximately 35-40% of its sales revenue comes from offering non-ratings services to clients. CRISIL claims that half of its sales come from "helping banks [abroad] with equity research and risk-management models, demand for which has soared thanks to more regulation in the rich world." *Id.*¶ 5. In fact, the company attributes its recognition of the need to diversify from the mid-1990s, when it downgraded many of its ratings. The downgrade caused many issuers to pull out their business, demonstrating to the company that it could not be solely dependent on its ratings service.

154. *Id.*

155. *Id.*

156. *Id.* ¶ 3.

157. *Id.*

158. *Id.*

Interestingly, Standard & Poor's has owned 52% of CRISIL since 2005, and Moody's owns 29% of ICRA.[159] With two of the Big Three holding significant shares in two of the biggest Indian credit rating agencies, it is unclear what the future holds in store for these developing firms. At the time of their creation, the agencies were sponsored by respectable, often state-controlled, financial firms.[160] This resulted in a handful of agencies deemed reliable according to public and governmental perception. However, as the Indian market continues to grow there is increasingly more room for "new entrants that might offer softer ratings to win market share."[161] Even if the existing credit rating agencies continue to offer diligent ratings and downgrade where necessary, the issuer-pays model will undoubtedly attract new agencies that may look to offer more favorable ratings in order to gain clients as Indian companies strive to become global financial players.

Finally, it is possible that India has not fully experienced the economic ripples stemming from the recent financial crisis. As the global economy continues to struggle, "the ratio of upgrades to downgrades [in India] is now heading towards parity" in comparison to recent years.[162] It is unclear how willing Indian credit rating agencies will be to downgrade major national financial institutions if necessary.[163] It is entirely foreseeable that the Indian agencies may hesitate to downgrade their major, often nationalized, institutions in the same way that the Western credit rating agencies did prior to the crisis and over the recent years. The Indian agencies remain largely untested as to how they would respond to the pressure of downgrading a major player at the risk of a negative backlash.[164]

VI. The Efforts of the International Organization of Securities Commissions

The International Organization of Securities Commissions (IOSCO) has also tackled the issue of credit rating agency regulation.[165] The IOSCO Technical Committee formed a task force that issued a report regarding the role of credit rating agencies in the global economy in September 2003.[166] In addition, IOSCO also issued a set of general principles designed to improve the ratings process that "related to the quality and integrity of the ratings process, independence and conflicts of interest, transparency and timeliness

159. *Id.* ¶ 3.
160. *Id.*
161. *Id.* ¶ 6.
162. *Id.* ¶ 7.
163. *Id.*
164. *Id.*
165. Karmel, *supra* note 2, at 869.
166. *Id.*

of ratings disclosure, and the use of confidential information."[167] IOSCO then issued a more specific Code of Conduct Fundamentals for CRAs,[168] which focused on specifically improving the integrity of the ratings process.[169] In recent years, IOSCO has issued an updated version of the Code[170] as well as urged international cooperation for the regulation of credit rating agencies.[171]

IOSCO issued a final report on credit rating agencies in February 2011,[172] comparing the implementation of CRA regulation in Australia, Brazil, the European Union, Japan, Mexico, Switzerland, and the United States.[173] Generally, it found that the four core principals promulgated by its Code of Conduct Fundamentals for CRAs had been fulfilled.[174] The four principles address: "(1) quality and integrity in the rating process; (2) independence and conflicts of interest; (3) transparency and timeliness of ratings disclosure; and (4) confidential information."[175] On one hand, IOSCO has painted itself as a key player in the harmonization of regulatory frameworks on an international scale. However, the generality of its suggestions, as demonstrated by the four core principles, indicates that IOSCO has only managed to set a minimum floor for regulatory frameworks that is easily attainable across a wide spectrum of countries.

VII. RESTRUCTURING THE CREDIT RATING SYSTEM

A. Increased Accountability for Rating Mistakes

The process of restructuring the credit rating system must begin with addressing the oligopoly of the credit rating market. Part of reforming the system of dominance established by S&P and the other Big Three agencies requires increased accountability for rating mistakes, like the $3 trillion miscalculation in the United States sovereign debt downgrade. Such errors

---

167. TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, REPORT ON THE ACTIVITIES OF CREDIT RATING AGENCIES 15-17 (2003), *available at* www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf.

168. TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES (2008), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf.

169. Karmel, *supra* note 2, at 869.

170. TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS*,* *supra* note 167.

171. *Id.*

172. TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, REGULATORY IMPLEMENTATION OF THE STATEMENT OF PRINCIPLES REGARDING THE ACTIVITIES OF CREDIT RATING AGENCIES (Feb. 2011), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD346.pdf.

173. Karmel, *supra* note 2, at 872.

174. *Id.*

175. TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS*,* *supra* note 172.

have an "immediate and significant impact on buyers and sellers of credit . . . [and] the overall performance of the financial markets."[176]

One proposal for increased accountability has recently been put forward by the SEC. The Commission is currently proposing to implement Sections 15E(r)(3)(C) of the Exchange Act under a new Rule 17g-8, which would "require an NRSRO to notify users of credit ratings when a significant error is identified in a procedure or methodology, including a qualitative or quantitative model, that may result in credit rating actions."[177] The proposed Rule 17g-8 would require the NRSRO to institute policies and procedures to post easily accessible information on its internet website regarding "significant errors identified in a procedure or methodology."[178] This proposal has been opened up for comments. In response, S&P sent an 84-page letter raising concerns and criticisms of the SEC proposal on August 8, 2011.[179]

However, even this proposal for a new Rule 17g-8 fails to have the necessary teeth for enforcing increased accountability for the substance of credit ratings. In its proposal, the SEC has not defined the term "significant error," inviting comments as to who should determine the definition and what the definition of the term should be.[180] The Commission's proposal does suggest a possible materiality threshold for determining the significance of the error.[181] A materiality threshold would be an important step for quantifying ratings mistakes and creating a comprehensive scale for imposing liability. Unfortunately, a materiality threshold is unlikely to pass into legislation due to concerted efforts by the credit rating agency lobby in Washington, D.C.[182] Nevertheless, the implementation of a universal materiality threshold remains a concrete method for evaluating the

---

176. Ryan, *supra* note 4, at 5.

177. Proposed Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-64514, 2011 WL 1894728, at *131 (Proposed May 18, 2011) (to be codified at 17 C.F.R. pts. 232, 240, 249, 249b).

178. *Id.*

179. Sarah N. Lynch, *S&P Balks at SEC Proposal to Reveal Rating Errors*, REUTERS, Aug. 10, 2011, *available at* http://www.reuters.com/article/2011/08/10/us-financial-regulation-sandp-idUSTRE77901S20110810. The comment letter came three days after the S&P downgraded the U.S. long-term sovereign debt. *See* Goldfarb, *supra* note 56.

180. Proposed Rules, *supra* note 177, at *136.

181. *Id.*

182. S&P has strongly argued against a Commission-instituted definition of "significant error," equating it to a substitution for the judgment of the CRAs. Notably, between January 2011 and August 2011, the Big Three spent well over $1 million lobbying Congress and federal agencies for changes in the CRA regulations, as the SEC prepared its 517-page proposal for additional policies and procedures in the face of the financial crisis failure. Lynch, *supra* note 179; *see also* Marian Wang, *What's a 'Significant Error'? Standard & Poor's Says Leave It To Us,* PROPUBLICA (Aug. 10, 2011), https://www.propublica.org/blog/item/whats-a-significant-error-standard-poors-says-leave-it-to-us/.

substance of credit ratings. On a global scale, such a threshold can also facilitate the process of standardizing ratings for various product classes.

B. Standardization of International Standards of Review for Credit Rating Agencies

The standardization of international standards of review will allow for the comparison of ratings among agencies and across financial product classes, as well as facilitate measures of accountability. According to its report to Congress regarding the standardization of credit rating agencies, the SEC has made findings that standardizing the credit rate terminology may be helpful in facilitating the comparison of ratings among the agencies.[183] However, the staff proposes that increasing transparency is a more feasible alternative to the pursuit of rating standardization among the CRAs.[184] Specifically, the staff recommends that "the Commission not take any further action . . . with respect to . . . standardizing credit rating terminology[;] . . . standardizing the market stress conditions under which ratings are evaluated; . . . standardizing credit rating terminology across asset classes" at this time.[185]

The decision to exclusively pursue transparency goals in favor of exploring standardization options is a blatant mistake. Transparency and standardization measures must not be mutually exclusive features of the credit ratings market. Both are essential features in the necessary restructuring of the credit rating system if it is to continue as a measure of institutional creditworthiness. Unfortunately, regulation under both ESMA and SEBI exhibit a similar emphasis on transparency.[186] Nevertheless, standardization remains the key to bridging the accountability gap faced by regulators. The lack of standardization allows credit rating agencies to attribute possible mistakes in methodology or calculation to rating disparities.[187] Instead, a standardization of the ratings would facilitate the ultimate goal of accountability among the competing agencies.

---

183. Report on Credit Rating Standardization, S.E.C., at 3 (Sept. 7, 2012), *available at* http://www.sec.gov/news/studies/2012/939h_credit_rating_standardization.pdf.

184. *Id.* at 4.

185. *Id.*

186. *See* EUROPEAN COMMITTEE B *supra* note 94; *see also* Laskar, *supra* note 142.

187. Dieter Kerwer poses an interesting argument that credit rating agencies actually monitor issuers through reputation. This has a dangerous domino effect during a financial crisis when the agencies begin to copy each other in order to avoid being the only firm with a different, lower rating. *See* DIETER KERWER, MAX-PLANCK-PROJEKTGRUPPE RECHT DER GEMEINSCHAFTSGÜTER BONN, STANDARDISING AS GOVERNANCE: THE CASE OF CREDIT RATING AGENCIES 5 (2001), *available at* http://www.coll.mpg.de/pdf_dat/2001_03online.pdf.

C. Mutual Recognition of Regulatory Frameworks

A necessary link between increased accountability and standardization is the mutual recognition of existing regulatory frameworks. ESMA, in particular, has shown its openness to this approach by extending mutual recognition to the equally "stringent" regulatory frameworks of the United States, Canada, Hong Kong, and Singapore in regard to credit rating agencies.[188] Adopting the mutual recognition approach allows "financial products and financial institutions free transit across national borders."[189] Therefore, a credit rating agency that is in compliance with the requirements of one regulator is able to gain recognition in other jurisdictions due to the recognition of the home regulatory framework.

Mutual recognition is necessary in all future regulatory efforts regarding credit rating agencies for two reasons. First, national regulators such as the SEC, ESMA, and SEBI share a common set of goals. Regulators are interested in creating efficiently functioning markets while protecting market participants. Second, credit rating agencies function on an international scope. Currently, agencies such as Standard & Poor's are independently registered with the SEC, ESMA, and SEBI. ESMA's mutual recognition of the United States regulatory framework effectively streamlines this process, demonstrating how regulators can function together in order to simplify their monitoring methods and avoid the delay of reconciling individual sets of regulations.

D. The Need for Mandatory Registration of All Credit Rating Agencies

Any additional requirements, viewed as burdens by credit rating agencies, consistently raise the issue of voluntary nullification. Agencies that wish to escape increasing regulation, particularly the Big Three, may simply deregister with the regulators like the SEC, thereby avoiding the heightened cost while continuing to issue credit ratings according to their internal policies and procedures. The opportunity for voluntary deregistration "deprive[s] society of a regulatory mechanism to effectively promote accurate and reliable ratings."[190] In his discussion of NRSRO Nullification in the United States context, Jason Parsont refuses to recommend legislatively closing the voluntary registration gap in favor of a

---

188. Kirwin*, supra* note 109.

189. ROBERTA S. KARMEL, NATIONAL TREATMENT, HARMONIZATION AND MUTUAL RECOGNITION – THE SEARCH FOR PRINCIPLES FOR THE REGULATION OF GLOBAL EQUITY MARKETS 13 (1993).

190. Parsont, *supra* note 6, at 1017.

mandatory registration requirement.[191] Unfortunately, Parsont stops short of the critical link to a new era of regulation for credit rating agencies. While regulatory agencies such as the SEC and ESMA have fully acknowledged the continued over-reliance on credit ratings in regulatory frameworks, recent efforts continue to tread softly when it comes to creating real teeth in the new regulations.

In the United States, the mistake of giving credit rating agencies too much maneuvering room should already have been learned when the agencies "refused" to submit to liability under Section 11 of the Securities Act of 1933.[192] Sovereign regulators must escape agency capture by mandating registration for all credit rating agencies.

In response to a request by the Obama administration in 2009, the U.S. Department of the Treasury assessed that mandatory registration for credit rating agencies, with certain exemptions, would satisfy First Amendment requirements.[193] Instead of allowing an agency to elect to be treated as an NRSRO,[194] the administration was interested in mandating NRSRO registration for all credit rating agencies.[195] Both ESMA[196] and SEBI[197]

---

191. Instead, Parsont proposes instituting a modified version of the Franken Proposal, which recommends the adoption of a clearing house-type CRA Board, although without the function of allocating initial rating assignments. Parsont, *supra* note 6, at 1018, 1021. He justifies the deletion of this key characteristic by also urging the adoption of the SEC proposal to "permit partial reliance by investment fiduciaries . . . under the new standards of creditworthiness," if they enter into an agreement regarding methodology with the credit rating agency. Parsont, *supra* note 6, at 1021.

192. Karmel, *supra* note 2, 872 n.227.

193. Constitutionality of Mandatory Registration of Credit Rating Agencies, 2009 WL 4325372 (Dep't of Justice Office of Legal Counsel, Oct. 22, 2009), *available at* http://www.justice.gov/olc/2009/opinion-letter-treasury.pdf.

194. *Contra* 15 U.S.C. § 78*o*-7(a)(1)(A) (2006).

195. Dep't of Justice, *supra* note 193, at 1-2. The Administration's proposal would exempt any agency that satisfies two requirements: "(i) it does not provide ratings of securities in exchange for fees or other forms of compensation from the securities' issuers; and (ii) it issues credit ratings only in any bona fide newspaper, news magazine or business or financial publication of general and regular circulation." Dep't of Justice, *supra* note 193, at 2. The second prong of the exemption is based on an existing criterion in the Investment Advisers Act. In its assessment, the Department of the Treasury finds that mandatory registration with the exemption, as stated, would comply with the First Amendment. Dep't of Justice, *supra* note 193, at 2. The First Amendment is often cited by credit rating agencies as a constitutional argument against regulation. *See* Ben Protess & Lagan Sebert, *Under Attack, Credit Raters Turn to the First Amendment,* COMMON DREAMS (Oct. 29, 2009), https://www.commondreams.org/headline/2009/10/29-0. *But see* Jonathan Stempel, *Federal Judge: Credit Ratings Not Always Protected Under First Amendment,* HUFFINGTON POST (Nov. 26, 2011), http://www.huffingtonpost.com/2011/11/26/federal-judge-credit-rati_n_1114034.html.

196. ESMA, *supra* note 116.

197. *Securities and Exchange Board of India (Credit Rating Agencies)Regulations, 1999*, SEBI (Jul. 7, 1999), *available at* http://www.sebi.gov.in/acts/CreditRatingAgencies.pdf.

continue to accept credit rating agency applications for registration rather than mandating registration for all entities functioning as credit rating agencies within their respective jurisdictions.

Mandatory registration has the drawback of being high-cost, particularly for smaller credit rating agencies. While agencies such as the Big Three may oppose mandatory registration as a step towards creating civil liability for the substance of ratings and rating methodologies, smaller firms may be pushed out of the market by the cost of complying with registration requirements. However, regulators can alleviate the cost burden of mandatory registration by balancing it with the pursuit of global standardization of ratings standards and mutual recognition of existing regulatory frameworks.

E. Imposing Performance-Based Sanctions

Perhaps the only solution that will truly inspire a responsible change in policies and procedures among credit rating agencies is the imposition of pocket-hitting penalties. Imposing performance-based sanctions would punish the agencies on an *ex post* basis if a regulatory body could demonstrate that the ratings were unreasonably high.[198] Professor John Coffee has proposed that the SEC tie NRSRO status to the default rates of an agency's ratings.[199] Specifically, "the SEC could establish a maximum default rate for each letter grade and suspend the NRSRO status of an agency whose five-year default rate exceeded that maximum . . . until its five-year default rate returned below the established parameter."[200] According to the Coffee Proposal, the SEC would still be able to limit the scope of the sanction, applying it to "a particular asset class and a particular rating."[201] This system is designed to counteract the conflict of interest created by the dominant issuer-pays model by forcing credit rating agencies to be more conservative in their ratings.[202]

Unfortunately, the Coffee Proposal presupposes the desirability of the registration status for the agencies and their desire to retain it at the cost of more conservative credit ratings for issuer–clients. As Professor Coffee himself points out, the Big Three may simply decide to surrender their registered status in order to skirt extensive regulation and costly compliance

---

198. Deryn Darcy, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 COLUM. BUS. L. REV. 605, 658 (2009).

199. John C. Coffee, Jr., *Grade Inflation*, 30 NAT'L L.J. 12 (2007); *cited in* Darcy, *supra* note 198, at 660 n.237.

200. Darcy, *supra* note 198, at 660.

201. *Id.* at 660.

202. *Id.* at 661.

under various legislation such as the Dodd–Frank Act or CRA I and II.[203] Therefore, the threat of a regulator suspending the registered status of a credit rating agency will not necessarily encourage ratings accuracy. Instead, large agencies such as the Big Three may opt to voluntarily nullify the status, delegating the punishment to smaller agencies. Subsequently, if those agencies are unable to survive the penalty, this only perpetuates the oligopolistic nature of the credit ratings industry.

On the other hand, Professor John Patrick Hunt proposes a solution that hits credit rating agencies directly in the pocket, "requiring a CRA to disgorge profits received from issuing ratings on new products that fall below a predetermined quality level unless the CRA reveals in advance that the ratings are of low quality."[204] Professor Hunt also allows for the possibility of privately contracted enforcement in addition to an SEC-implemented administrative structure for collecting penalties.[205] The Hunt Proposal includes suggestions for measuring low quality ratings; for example, applying an accuracy ratio, setting a minimum quality level below which the market cannot function, or comparing the default rates of products across different classes as a uniform benchmark.[206]

Unquestionably, the Hunt Proposal pinpoints a penalty that will catch the attention of all credit rating agencies. However, the proposal presents logistical difficulties in terms of implementation. By neglecting to pinpoint a system for collecting the low quality penalty amounts, it skirts the issue of assigning enforcement responsibility. Furthermore, even if this responsibility is delegated to an existing regulatory agency such as the SEC or ESMA, opposition to its implementation may stall and ultimately destroy it prior to any effect on credit rating accountability. The Big Three agencies, as well as smaller firms, have vehemently lobbied against reform in response to arguably smaller accountability measures such as the formal definition of "significant error." It is almost impossible to imagine that the agencies would allow an entire system of disgorgement of profits in connection with low quality credit ratings to go into effect. While implementation difficulty certainly should not function as a deterrent in pursuing reforms in the credit ratings industry, such difficulty threatens to make the proposal ineffective due to the sheer amount of time that it will be stalled in the process of comments, hearings, and intensive lobbying by the agencies.

---

203. John C. Coffee, Jr., *Ratings Reform: The Good, the Bad, and the Ugly,* 1 HARV. BUS. L. REV. 231, 264 (2011).

204. John Patrick Hunt, *Credit Rating Agencies and the Worldwide "Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 112 (2009); *cited in* Darcy, *supra* note 198, at 661.

205. Darcy, *supra* note 198, at 661-62.

206. *Id.* at 662.

VIII. CONCLUSION

Recent efforts by the SEC, ESMA, and newer entities like SEBI have started the process of reforming the regulatory framework of the credit rating industry. At the very least, the organizations have acknowledged the overreliance on credit ratings within existing regulation. As a staple of the global economy, credit rating agencies are a dangerous market element if left unchecked, particularly due to the oligopolistic nature of the industry. During the Enron collapse and the recent downgrade of the U.S. sovereign debt, power players such as Standard & Poor's have repeatedly demonstrated the toxic impact of inaccurate ratings.

Existing regulation in the United States, the European Union, and emerging markets like India have started the process of tightening controls for the credit ratings industry. However, along with existing regulation, a number of changes are still necessary in order to successfully overhaul the credit rating system. Specifically, regulators must establish increased accountability measures for rating mistakes. Also, international standards of review and regulation of the agencies must be created in order to allow comparison between ratings and to facilitate further measures of accountability. Regulators such as the SEC, ESMA, and SEBI must make a concerted effort to extend mutual recognition to other regulatory frameworks in order to create a comprehensive and overlapping system of regulation and monitoring. Finally, regulators must pursue mandatory registration of all credit rating agencies under a standardized system of regulation that protects both credit rating agencies and other market participants. While proposals to impose performance-based sanctions pose an interesting hypothetical, the strength of industry opposition likely makes an attempt at implementation cost-prohibitive.