CREDIT RATING AGENCIES: A REGULATORY CHALLENGE FOR AUSTRALIA

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[This article identifies a number of structural and operational deficiencies inherent in credit rating agencies' ('CRAs') current business model and rating methodologies. It is argued that CRAs' reputational capital alone is not sufficient to protect the integrity of the CRA market or to ensure efficient and transparent functioning of their businesses. Prescriptive operational rules are justified and necessary in order to address the conflicts of interest which are inherent in the issuer-pays business model, particularly in structured finance operations. An efficient inspection, surveillance and supervision regime is also essential to maintaining the credibility of the issuer-pays business model and CRAs' reputation. Australian law-makers and the Australian Securities and Investments Commission should consider some of the specific operational measures proposed by the United States and European Union regulators and remove CRAs' current exemption from the requirement to hold an Australian Financial Services Licence. This article also proposes the creation of an external oversight board inspired by the US Sarbanes-Oxley Act*, which would serve as a means of promoting enhanced transparency of governance and restoring CRAs' reputational capital.]*

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I Introduction

The global market failure of 2008 and the end of the investment banking era[1] have reinvigorated an earlier debate about the form, extent and importance of regulation of financial markets intermediaries. Credit rating agencies ('CRAs')[2] perform an important intermediary function in the global financial markets. They rate debt obligations based on the ability of issuers to make timely payments. Their ratings are used by borrowers, investors, pension funds, banks and governments from around the world to make informed investment and financing decisions. Critics have argued that CRAs failed to perform their function as institutional 'gatekeepers' during the recent crisis by giving favourable ratings on the creditworthiness of historically unproven and structurally unstable financial instruments.[3]

A number of commentators, international forums and regulatory groups have scrutinised the organisational aspects of the CRAs' business model and debated the merits of more intrusive regulatory oversight on innovation, competition and business transparency. With respect to the organisational aspects, some of the issues such as internal governance, independence and conflicts of interest were identified several years prior to the current crisis but have remained areas of ongoing concern. It will be argued that these problems are symptomatic of the underlying structural inadequacies inherent in the issuer-pays and self-regulation models. With the rapid rise of structured finance, these problems have become even more pronounced whilst the substantively new issues of credibility and reliability of the rating process and its methodology have come to the fore.

This article will also discuss the broader policy issues, such as the desired form and extent of regulation and its effects on innovation, informational asymmetries and competition. It is argued that the status of the CRA as a 'gatekeeper' is an important conceptual determinant in this regard because a number of important

1 According to the International Monetary Fund, the 2007–08 credit crisis was 'the largest financial shock since the Great Depression': International Monetary Fund, *World Economic Outlook: April 2008 — Housing and the Business Cycle* (2008) 4. See also George Soros, Statement to Committee on Oversight and Government Reform, US House of Representatives, *Hedge Funds and the Financial Market*, 13 November 2008, 3. It resulted in the disappearances of prominent Wall Street investment firms and banks such as The Bear Stearns Companies and Lehman Brothers Holdings, whilst the remaining investment banks such as Goldman Sachs have turned themselves into deposit-taking institutions with all the regulatory consequences that follow: see Julie Creswell and Ben White, 'Wall Street, RIP: The End of an Era, Even at Goldman', *Business*, *The New York Times* (New York), 28 September 2008, 1.

2 This paper uses the term CRAs to refer to credit rating agencies in general and the main three CRAs in particular, given that these CRAs rate almost 100 per cent of all public debt in Australia and internationally. These are Standard & Poor's ('S&P'), Moody's Investors Service ('Moody's'), and Fitch Ratings ('Fitch'): see Frank Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers' in Yasuyuki Fuchita and Robert E Litan (eds), *Financial Gatekeepers: Can They Protect Investors?* (2006) 59, 61; 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] *Columbia Business Law Review* 109, 114–15; Sean J Egan, Testimony to the Committee on Oversight and Government Reform, US House of Representatives, *Credit Rating Agencies and the Financial Crisis*, 22 October 2008, 1.

3 See generally Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 60; Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (2008) 32–3, 36–7 ('*Financial Stability Forum Report*').

'gatekeeper' reforms have taken place in the wake of the Enron scandal. Accordingly, it is suggested that an industry-run oversight board co-supervised by a regulator may, along with other forms of supervision, be an appropriate self-governing body for the CRA industry.

It is also argued that recent regulatory developments in the US and the European Union ('EU') point to a clear consensus among law-makers that effective supervision and enforcement are the *sine quibus non* requirements for ensuring the credibility and reliability of the issuer-pays business model. A related issue for law-makers will be determining the extent to which they should promote institutional reliance on the ratings as part of their legal frameworks and whether any model reliance can be effectively supported by regulatory or market-based mechanisms in order to ensure rating accuracy.

Regardless of the outcome of the above debates in international fora, an issue of local concern is that the financial regulatory authorities in Australia have, by and large, failed to either debate or regulate the conduct of CRAs or their relationship with issuers or investors. It is perhaps most symptomatic of this 'wait-and-see approach' that CRAs and investment banks have been specifically exempted from the requirement to hold an Australian Financial Services Licence during a period which was characterised by major financial services reforms, conflicts of interest and market failures involving these institutions.[4]

One of the aims of this article is to contribute to the debate in Australia by providing an overview of the CRAs' role in the recent financial crisis, as well as the conceptual and operational issues encountered by the law-makers in the US and the EU. The US Congress, the Securities and Exchange Commission ('SEC') and the Commission of the European Communities ('European Commission') have separately initiated significant reforms which aim to increase efficiency, transparency and competition, as well as to manage the conflicts of interest inherent in the CRAs' operating models and methodologies. It will be argued that due to the 'manifest failure of self-regulation', the regulatory measures proposed by the international law-makers are both justified and necessary 'to ensure high standards of independence, integrity and professional diligence' on the part of CRAs.[5]

Part II of this article examines the role of the CRAs during the market failure of 2008 and outlines the problems inherent in their rating processes and methodologies. It also discusses the issues of ratings credibility and reliability, and the reasons for investor reliance. Part III discusses the operational and internal governance problems which have been identified during the recent crisis and outlines the issues most relevant to law reform. Part IV examines the theoretical and conceptual dilemmas facing the regulators and discusses the most significant

4 Australian Securities and Investments Commission ('ASIC'), *Credit Rating Agencies*, Class Order No 03/1093, 23 December 2003, replaced by ASIC, *Credit Rating Agencies*, Class Order No 05/1230, 31 December 2005.

5 European Commission, *Proposal for a Regulatory Framework for CRAs* (2008) 1 ('*European Commission's Consultation Document*'). The Commission describes its policy as a response to 'the manifest failure of self-regulatory efforts, both formal and informal, to ensure high standards of independence, integrity and professional diligence.'

features of the recent US and EU law reform proposals. The article concludes that the measures proposed by the US and EU are both justified and necessary, and recommends the adoption of a number of these proposals and legal concepts into Australian law.

II RATINGS, RELIANCE AND RELIABILITY

A *A Flawed Rating Methodology*

It has been generally accepted that the CRAs have played an instrumental role in the problems that have arisen in the structured credit markets, particularly with respect to the rating of complex financial instruments called collateralised debt obligations ('CDOs').[6] The CRAs gave the highest possible ratings on the creditworthiness of CDOs based on 'inadequate historical data and in some cases flawed models.'[7] According to the Financial Stability Forum, many of the ratings were based on quantitative statistical models that contained limited historical data about the underlying pools of assets and instead relied heavily upon complex mathematical assumptions and information provided by the issuers.[8] In addition, a large proportion of the CDOs were secured by subprime residential mortgage-backed securities ('RMBSs') of historically unproven credit risk value.[9]

The Committee on the Global Financial System of the Bank for International Settlements warned in 2005 that the empirically untested, model-based risk assessments could be 'a long way from "true" values' and that the rating methodology was potentially the most significant risk factor to which the investors had been exposed.[10] The Committee concluded that '[u]se of structured finance instruments, together with the occurrence of worst case scenarios relating to mispriced or mismanaged exposures, might thus lead to situations in which extreme market events could have unanticipated systemic consequences.'[11] The predictions turned into reality after the value of the underlying pool of RMBSs

6 See ibid; *Financial Stability Forum Report*, above n 3, 5–6, 32; Technical Committee of the International Organization of Securities Commissions ('IOSCO'), *The Role of Credit Rating Agencies in Structured Finance Markets: Final Report* (2008) 2 ('*IOSCO Final Report*').

7 *Financial Stability Forum Report*, above n 3, 32.

8 Ibid 33. See also Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 76–7. See generally Frank L Raiter, Written Statement to the Committee on Oversight and Government Reform, US House of Representatives, *Credit Rating Agencies and the Financial Crisis*, 22 October 2008, 3–7.

9 *Financial Stability Forum Report*, above n 3, 33. See also Raiter, above n 8, 4–5. According to Raiter, S&P's quantitative assumptions were based upon very limited historical and loan pool data. He states that S&P's models were initially built on a pool of only 500 000 loans. A subsequent version of the model was based on 900 000 loans. Two further versions of the model had been developed by 2004, with the most recent based on a pool of 9.5 million loans. Neither of these, however, were implemented due to funding constraints.

10 Committee on the Global Financial System, Bank for International Settlements, *The Role of Ratings in Structured Finance: Issues and Implications* (2005) 24.

11 Ibid 3. See also *IOSCO Final Report*, above n 6, 2: 'observations relating to the market for certain structured finance instruments … raised questions about the quality of CRA ratings and the independence of the CRAs rating RMBSs and CDOs.'

diminished due to a statistically unanticipated housing market depreciation in the US.[12] The downturn in the housing market was accompanied by an unprecedented number of subprime mortgage delinquencies and defaults.[13] Together, these events significantly devalued the pool of RMBSs, prompting the CRAs to issue rapid downgrades of the CDO ratings.[14] The rating downgrades triggered a global liquidity crisis and significantly devalued the market in global financial debt obligations worth trillions of dollars.[15] According to Jerome Fons, once 'the pace of [the rating] downgrades accelerated, market participants began to question the reliability of [all] ratings … to the point where no financial institution was willing to lend to another.'[16]

Professor Frank Partnoy has argued that the statistical models were essentially flawed in that they provided the markets with an opportunity to arbitrage the CRAs' mistakes, rather than the risk profiles of the underlying assets.[17] According to this view, the process of rating the CDOs was largely a mathematical game in which quantitative experts, who understood the details of the models, could manipulate the risks and 'tweak' the inputs, assumptions and the underlying assets to produce CDOs that appeared to add value, although in reality did not.[18] A further identified flaw in the rating methodology was the unexplained failure by the quantitative models to capture the so-called 'default contagion', a process characterised by a statistical interdependence of credit defaults. Professor John Coffee defines the default contagion as the type of default by one or more borrowers which increases the likelihood that other borrowers would also default.[19]

12 See Transcript of Proceedings, Committee on Oversight and Government Reform, US House of Representatives, Washington DC, 22 October 2008, 51 (Sean J Egan, Managing Director of Egan-Jones Ratings) ('*Transcript of US House Committee*'). According to Egan, CRAs had been so confident that house prices would always appreciate that they devised a statistical 'house appreciation rate' acronym which was used in their risk valuation models. See also Soros, above n 1, 1:

> The proximate cause is to be found in the housing bubble or more exactly in the excesses of the subprime mortgage market. The longer a double-digit rise in house prices lasted, the more lax the lending practices became. In the end, people could borrow 100 percent of inflated house prices with no money down. Insiders referred to subprime loans as ninja loans — no income, no job, no questions asked.

13 See SEC, *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, 73 Fed Reg 36 212, 36 216–17 (25 June 2008) ('*Proposed SEC Rules*'). According to the SEC, the S&P delinquency rate for subprime loans was 4.97 per cent in 2005, 10.55 per cent in 2006, and 15.19 per cent in 2007: at 36 217.

14 Ibid 36 216–17.

15 Ibid 36 213–14, 36 216–18. For example, Fitch issued downgrades to approximately 30 per cent of subprime based securities: at 36 217. See also Raiter, above n 8, 2.

16 Jerome S Fons, Testimony to Committee on Oversight and Government Reform, US House of Representatives, *Credit Rating Agencies and the Financial Crisis*, 22 October 2008, 2.

17 Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 75–6.

18 Ibid 76–80. Partnoy states that '[h]owever sophisticated the techniques, they are subject to the limitations of "garbage in, garbage out"': at 77.

19 John C Coffee Jr, Testimony to Committee on Banking, Housing and Urban Affairs, US Senate, *Turmoil in the US Credit Markets: The Role of Credit Rating Agencies*, 22 April 2008, 4.

B *Reliance without Reliability*

The second issue of regulatory concern in relation to the rating process is that investors and financial institutions from around the world relied on the CRAs to provide accurate and unbiased valuations of financial debt instruments. A number of reasons have been put forward for investor reliance. The first is that there was insufficient opportunity for independent verification of the composition and characteristics of the underlying security pools.[20] In other words, investors were not privy to the instrument information that would have allowed them to understand the quality of the underlying assets.[21]

Notably, the underlying asset-specific data was generally not analysed by the CRAs either.[22] Professor Coffee rightfully questions the wisdom of investor reliance in such circumstances. To demonstrate this point, he compared the process of issuing CDO ratings to that of issuing corporate bonds, which also does not involve verification of the data. However, he points out that the corporate bonds issuer is typically subject to stringent auditing and reporting regimes and also has other securities traded in the markets.[23] In contrast, he argues that the CRAs' failure to audit or verify CDO security information appears 'the equivalent of an auditor accepting an issuer's statements about its revenues, costs, inventories and contingent liabilities at face value.'[24]

The second reason for investor reliance lies in the complexity of the risk modelling processes employed by the issuers and the CRAs.[25] As foreshadowed, these processes generally require sophisticated quantitative risk models, sufficient human resources and technical expertise to assess the risks, even if all the data is readily available.[26] George Soros states that some of the models 'reached such heights of complexity that [even] the regulators could no longer calculate the risks' and instead had to rely themselves on the models provided by the financial institutions.[27] The quantitative complexity of the models was further compounded by the fact that the securities were embedded into hybrid financial instruments and equally esoteric legal structures which are less transparent and

20 See *Financial Stability Forum Report*, above n 3, 33, 36–7; *IOSCO Final Report*, above n 6, 9; ibid 3–4.

21 Fons, Testimony to Committee on Oversight and Government Reform, above n 16, 2.

22 Ibid. See also SEC, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies* (2008) 9 ('*SEC Examination*'); *Financial Stability Forum Report*, above n 3, 37; Raiter, above n 8, 7. According to the SEC, the CRAs' analyses were based primarily on the credit rating of each RMBS or CDO in the underlying pool and did not include an analysis of the underlying assets in those instruments.

23 Coffee, above n 19, 9.

24 Ibid. See also *Financial Stability Forum Report*, above n 3, 33, 36–8. One of the reasons for the lack of interest in the securities lies in the originate-to-distribute nature of the securities, whereby the issuers were interested in quick repackaging and sales of the securities: at 8–10; *IOSCO Final Report*, above n 6, 5.

25 Fons, Testimony to Committee on Oversight and Government Reform, above n 16, 2; Committee of European Securities Regulators ('CESR'), *The Role of the Credit Rating Agencies in Structured Finance* (Consultation Paper No 08-036, 2008) 8, 10.

26 See *IOSCO Final Report*, above n 6, 7–8; Raiter, above n 8, 6.

27 Soros, above n 1, 7.

far more complex than traditional corporate debt instruments.[28] As a result, according to Gary Gorton, it was practically impossible to evaluate the risk profiles of these structures based upon information about the underlying securities alone.[29] Thus, an informational asymmetry was facilitated rather than reduced — via the intermediary — because of the difficulty of penetrating through the chain to the core assets.[30]

The third identified reason for investor reliance is that the CRAs have built a strong market reputation for being competent, honest and diligent arbiters of risk.[31] Because of this acquired reputation, their credit rating was viewed not only as an opinion on the risk profile of the securities, but also as a de facto 'seal of approval.'[32] According to the International Organization of Securities Commissions ('IOSCO'), this perception was significant in structured finance ratings because the rating served as an independent informational input about complex transactions.[33] Indeed, an investor survey conducted by the Bank for International Settlements found that the ratings were regarded as even more important in structured finance than for traditional debt instruments.[34] Despite the investors' reliance, however, the informational, qualitative and predictive value of the ratings remains debatable. This is not only because of the lack of access to the underlying data pools, but also because the response of the CRAs in downgrading investments has historically been slower than the market response.[35]

C *Regulatory Licences*

The final, and arguably the most significant, reason for investor reliance is the regulatory and transactional value of the ratings.[36] According to Amélie Champsaur, institutional reliance on the ratings takes the form of either implicit or explicit regulatory stipulations or transactional triggers in commercial contracts that can significantly affect the rights of the parties.[37] In both situations, CRAs

28 *IOSCO Final Report*, above n 6, 7–8. See also Soros, above n 1, 7.

29 Gary Gorton, 'The Subprime Panic' (Working Paper No 08-25, International Center for Finance, Yale School of Management, 2008) 26–7 <http://ssrn.com/abstract=1276047>.

30 Ibid 27. See also Soros, above n 1, 7.

31 Fons, Testimony to Committee on Oversight and Government Reform, above n 16, 2; *IOSCO Final Report*, above n 6, 8.

32 *IOSCO Final Report*, above n 6, 8. See also *Financial Stability Forum Report*, above n 3, 34.

33 *IOSCO Final Report*, above n 6, 8.

34 See Committee on the Global Financial System, above n 10, 22, 40. Several reasons were identified for investor reliance, including: 'the rating agencies' role in modelling the risks of complex structured finance instruments; their key role in deal structuring; and [their] clear information advantage, in particular over less sophisticated investors': at 40. The Committee noted that '[a] number of investors … claim to rely almost exclusively on the rating agencies' pre-sale reports and rating opinions for information on deal specifics and performance': at 23.

35 Amélie Champsaur, 'The Regulation of Credit Rating Agencies in the US and the EU: Recent Initiatives and Proposals' (LLM Thesis, Harvard University, 2005) 19–20 <http://www.law.harvard.edu/programs/pifs/pdfs/amelie_champasaur.pdf>.

36 Ibid 22–3. See generally Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 60–1, 81–3.

37 Champsaur, above n 35, 23–4. This issue has also been analysed in detail by Partnoy: Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 81–3;

fulfil a function similar to that of external auditors because they are creating rights and making transactions possible rather than merely reducing transaction or capital costs.[38] In borrowing contracts, for example, institutional lenders may become entitled, upon a rating downgrade, to exercise certain rights, such as an interest rate penalty.[39] Thus, from the parties' perspective, a change in the rating status can be seen as an easily identifiable, impartial and public event of default.[40] Similarly, in the regulatory setting, credit ratings have been incorporated into hundreds of rules and guidelines in the areas of public finance, securities, pensions, real estate and banking.[41] Like commercial contracts, regulations often contain the so-called 'credit cliffs' terms, which trigger the loss of favourable regulatory treatment due to a rating downgrade.[42]

Whilst regulatory reliance on ratings has been particularly widespread in the US, the recent crisis has demonstrated that Australian local governments, councils and financial institutions have also been significantly affected by this issue.[43] Indeed, Australian institutions have had a long history of regulatory reliance on credit ratings, not only at the local government level,[44] but also at the level of general public fiscal policy[45] and prudential standards regulation.[46] In

Frank Partnoy, 'The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Ratings Agencies' (1999) 77 *Washington University Law Quarterly* 619, 681–703.

38 Champsaur, above n 35, 22.

39 Ibid.

40 Ibid 23.

41 Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 82–3. See Adam Creighton, Luke Gower and Anthony Richards, 'The Impact of Rating Changes in Australian Financial Markets' (Research Discussion Paper No 2004-02, Reserve Bank of Australia, 2004) 2:

> For example, the *Investment Company Act of 1940* [and 17 CFR 270.2a-7(a)(10)(i) (2008)] requires that money market funds invest only in securities rated in the two highest categories. The investment grade distinction is also important in the *Federal Deposit Insurance Act* [12 USC § 1831e(d)(4)(A) (2006)], where corporate debt is only 'investment grade' if rated in one of the four highest categories.

42 Champsaur, above n 35, 35.

43 Michael Cole, *Review of NSW Local Government Investments: Final Report* (2008) 14. Cole estimates that local councils in New South Wales alone have suffered losses of approximately A$320 million on their investment portfolios linked to subprime CDOs.

44 Martin Gold, 'Financial Sustainability and the Imperative for Reform in Investment Organisation in Australia's Local Government Sector' (2008) 14 *Journal of Accounting, Accountability and Performance* 35, 46–7, 56. According to Gold, a notable feature of investment policies which apply in the local government sector in Victoria and NSW is the use of credit ratings to develop approved lists for short-term and long-term debt issues. Councils in Victoria and NSW are required to consider specific objectives prior to investing, such as risk and return, liquidity, diversification, as well as a prescriptive list with minimum credit ratings for short-term and long-term debt securities: *Local Government Act 1989* (Vic) s 143; Department of Treasury and Finance (Vic), *Prudential Statement on Investment Powers of Councils* (1998); *Local Government Act* 1993 (NSW) s 625(2); Minister for Local Government (NSW), '*Local Government Act 1993* — Investment Order (Relating to Investments by Councils)' in New South Wales, *Government Gazette*, No 97, 15 August 2008, 7638.

45 Creighton, Gower and Richards, above n 41, 2. According to the authors, there are a number of public finance areas in which CRA ratings are explicitly used. For example (at fn 3):

> General insurers can use credit ratings to determine counterparty risk weightings …; mortgage insurers must be rated at least 'A' for Authorised Deposit-taking Institutions (ADIs) to receive a concessional risk weighting for insured mortgages …; and, ratings are one of the criteria for determining whether certificates of deposit and bank bills can be categorised as 'high quality liquid assets' …

addition to the formal regulatory recognition of credit ratings in Australia, some authors have also pointed to the soft-disciplining role that the CRAs have had on public fiscal policy in general. For example, Geoff Anderson argues that the CRAs have effectively assumed the management of some state governments' public sector processes because they dictate the manner in which those governments can raise funds from the world financial markets.[47]

The practice of regulatory reliance has been criticised by both legal and economic scholars. Professors Partnoy and Coffee have separately argued that the practice is methodologically unsound and inherently anti-competitive because it favours the well-established firms and hinders competition.[48] Professor Catherine Lubochinsky and Dr Oliver Raingeard have also highlighted the SEC's own role in cementing the CRA oligopoly since the 1970s, when it adopted a non-transparent Nationally Recognized Statistical Rating Organization ('NRSRO') designation, which dissuaded many competitors from seeking to enter the market.[49] They identify this as one of the main reasons why the three CRAs today rate practically all of the public corporate debt obligations in the US.[50] The concerns about the lack of competition and transparency prompted the US Congress to introduce new legislation, the *Credit Rating Agency Reform Act of 2006* ('*CRA Reform Act*'), which formalised the registration process and introduced measures designed to improve the conditions for competition, procedural transparency and operational oversight.[51] It is argued below that the new measures have had an immediate impact on CRAs' business practices because they also provided the SEC with limited inspection and examination powers.

46 See Australian Prudential Regulation Authority ('APRA'), *Guidelines on Recognition of an External Credit Assessment Institution* (2008) 12–13 ('*APRA Guidelines*'). Australia has agreed to implement the Basel II Framework of the Basel Committee on Banking Supervision, which allows banking institutions to use credit ratings from CRAs, called External Credit Assessment Institutions ('ECAIs'), when calculating their net capital reserves: at 3. See also APRA, 'Implementation of Basel II in Australia' (Press Release, 3 November 2004); Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework — Comprehensive Version* (2006).

47 Geoff Anderson, 'Standard Bearers for the Markets: International Credit Rating Agencies, New Actors in Politics and Public Policy' (Paper presented at the Australasian Political Studies Association Conference, Adelaide, 29 September – 1 October 2004) 4. In this paper, Anderson explains the process of CRAs' integration into the broader regulatory structure of public administration in Australia and the means by which the requirements of global financial markets were transmitted to the public sector.

48 See generally Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 90–1; Coffee, above n 19, 1, 17.

49 Catherine Lubochinsky and Olivier Raingeard, 'Comments on the Proposal for a Directive/Regulation of the European Parliament and of the Council on Credit Rating Agencies', Submission to the European Commission, *Consultation on Policy Proposals regarding Credit Rating Agencies*, 5 September 2008, 8–9. According to Lubochinsky and Raingeard, the SEC did not disclose applications for recognition as an NRSRO and did not define the planning processes used for its decisions. They cite the example of the Lace Financial Corporation application, which took eight years to process: at 9. See also *Financial Stability Forum Report*, above n 3, 38.

50 Lubochinsky and Raingeard, above n 49, 8–9. Lubochinsky and Raingeard refer to S&P's Corporate Ratings Criteria in which S&P admits that it rates 99.2 per cent of the debt obligations and preferred stock issues in the US: at 9.

51 Pub L No 109-291, 120 Stat 1327.

However, aside from the competition concerns caused by regulatory reliance, the main criticism is probably not directed at the practice of regulatory reliance *per se*, but rather at the enhanced status, which creates a demand for ratings that is not directly attributable to their quality.[52] In other words, regulatory reliance may have given investors the '"illusion" that ratings are necessarily reliable and credible.'[53] Consequently, any contemplated reforms in relation to the ratings process must address the issue of ratings transparency, as well as the rigour and consistency of the methodologies used by CRAs. Under such an approach, the regulator would require CRAs to publish comprehensive statistics and disclose full particulars of the rating methodologies together with historical and comparative data on performance, liquidity and other 'mappable' characteristics.[54]

The *CRA Reform Act* currently only requires a CRA to provide a general description of the methodologies used at the time of their registration,[55] which is not satisfactory in view of the methodology flaws identified above. A more recent proposal adopted by the European Commission ('*EU Proposal*') is arguably more adequate, for it will place a further obligation on CRAs to publicly disclose all the key assumptions and methodologies used as well as to keep them up-to-date and under constant review.[56] The *EU Proposal* will also require standardised disclosure of performance data to be publicly available for comparison, including information about the volatility, loss and cash flow analysis performed on structured finance ratings, none of which were previously disclosed by CRAs.[57]

In Australia, there are existing rating methodology guidelines developed by APRA, which require that:

> The methodology for assigning credit assessments must be rigorous, systematic, and subject to some form of validation based on historical experience. Moreover, assessment must be subject to ongoing review and responsive to changes in financial condition. Before being recognised by supervisors, an assessment methodology for each market segment, including rigorous

[52] See *IOSCO Final Report*, above n 6, 8–9.

[53] Lubochinsky and Raingeard, above n 49, 10.

[54] Ibid 13–14. Lubochinsky and Raingeard recommend the approach in Committee of European Banking Supervisors, *Guidelines on the Recognition of External Credit Assessment Institutions* (2006), which takes into account CRAs' relative and absolute performance, their rating 'power curve', their average rating prior to default, a comparison of stability of the ratings based on those measures, and a comparison of the rating differences.

[55] *Securities Exchange Act of 1934*, 15 USC § 78o-7(a)(1)(B)(ii) (2006), as amended by *CRA Reform Act* § 4(a).

[56] European Commission, *Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies* (2008) art 7. The proposal has been sent to the EU Parliament and Council for adoption. See also *Proposed SEC Rules*, above n 13, 36 233, in which the SEC proposes modifications to *Securities Exchange Act of 1934*, 15 USC § 78o-7(a)(1)(B)(ii) (2006), requiring enhanced disclosure of rating methodologies and verification of loan pool data.

[57] See *EU Proposal*, above n 56, art 9, annex I sections D(II)(1), E(I). The *EU Proposal* provides that '[w]here a credit rating agency rates a structured finance instrument, it shall provide in the credit rating information about loss and cash flow analysis it has performed': at annex I section D(II)(1).

> back-testing, must have been established for at least one year and preferably three years.[58]

Significantly, APRA also states that it will regularly review the reliability of the methodologies and withdraw the External Credit Assessment Institution ('ECAI') recognition if the CRAs cease to comply with the recognition criteria.[59] However, despite the suggested element of supervision by APRA, it should be noted that the *APRA Guidelines* currently have relatively limited practical scope, because they operate only in relation to Basel II Accord and certain other prudential standards.[60] Nevertheless, the Australian securities regulators should take into account both the proposed EU disclosure requirements as well as APRA's criteria in formulating their policy, even if the latter do not address the overall standards of CRAs' market-based ratings or methodologies.

An alternative approach has been suggested to remove, or at least to significantly reduce, regulatory reliance on ratings. For example, a recent US proposal seeks to remove the references to CRA ratings in all but a small number of non-public reporting or record-keeping rules, which are unlikely to contribute to any further reliance on NRSRO ratings by market participants.[61] This proposal has been welcomed by Partnoy, who has argued against the practice of using references to NRSRO ratings in regulations for more than a decade.[62]

A further alternative proposal has also been made that would place the responsibility for the quality assurance of ratings fully on the investor rather than the regulator.[63] For example, Frank Raiter has recommended that national investment strategy regulations should require investors to obtain a minimum number of multiple ratings and that investors should devise the best surveillance mechanism to keep themselves informed as to how the ratings are performing.[64] However, whilst such a proposal may increase the overall competition and introduce new CRAs into the market, this may also contribute to the practice of 'rating shopping' rather than improve rating reliability.

58 *APRA Guidelines*, above n 46, 5. Annex 4 provides (at 12) that:
  (1) APRA … will review:
    (a) the size and the scope of the pool of issuers the ECAI covers;
    (b) the range and meaning of the credit assessments that it assigns;
    (c) the statistical significance of the ECAI's default rates; and
    (d) the definition of default used by the ECAI.
  (2) In addition to the qualitative factors outlined above, APRA will also have regard to other relevant factors such as:
    (a) the variable used to weigh default events;
    (b) geographical coverage; and
    (c) dynamic properties and characteristics of the ratings system or methodology.

59 Ibid 11.

60 See, eg, the matters listed by Creighton, Gower and Richards: see above n 45.

61 SEC, *References to Ratings of Nationally Recognized Statistical Rating Organizations*, 73 Fed Reg 40 088, 40 089 (11 July 2008).

62 Frank Partnoy, Submission to SEC, *References to Ratings of Nationally Recognized Statistical Rating Organizations*, 5 September 2008, 1.

63 See, eg, *Transcript of US House Committee*, above n 12, 76 (Frank L Raiter).

64 Ibid.

D *The Failure of Reputational Capital*

Against the above background an important doctrinal conclusion can be made about reliance and reliability. Namely, it appears that the recent events have discredited the so-called 'reputational capital' theory, which claims that the reputation of a business operates as a market-based mechanism for ensuring the highest standards of quality. Professor Steven Schwarcz, for example, has argued that, under certain conditions, reputation alone could act as a sufficient substitute for regulation because it has the disciplining effect of driving accountability.[65] He points to previous historical evidence from Moody's Investors Service ('Moody's') to support his assertion that the lack of regulatory scrutiny has not significantly affected ratings accuracy of the traditional debt instruments over several decades.[66]

However, Schwarcz's 'reputational capital' argument cannot be supported by any empirical evidence from the recent crisis. On the contrary, existing evidence leads to the clear conclusion that there are significant qualitative differences between the historical performances of the traditional debt ratings and the structured finance product ratings.[67] John Hunt's empirical and historical analysis of the recent crisis suggests that there were far more multi-notch downgrades among the structured finance ratings than there were among the traditional debt ratings.[68] Based on these observations, Hunt concluded that the CRAs' reputation for ratings of traditional bond instruments did not pose a sufficient deterrent against low-quality ratings of new products such as CDOs.[69] In other words, reputational capital may be product-specific rather than business-specific.

Hunt makes another important observation. He states that investors' reliance on the CRAs' reputations may have been misplaced not only because of the novel nature of the rated instruments and complex methodologies, but also because the CRAs had sufficient financial motivation to risk losing reputation on their businesses as a whole.[70] This raises important questions about conflicts of interest and transparency of the CRAs' business operations, which are analysed in the following Part.

[65] Steven L Schwarcz, 'Private Ordering of Public Markets: The Rating Agency Paradox' [2002] *University of Illinois Law Review* 1, 15.

[66] Ibid 13. Schwarcz cites a 1991 article, which states 'that in 20 years only one company with an investment-grade rating from Moody's ha[d] defaulted on long-term debt': 'Beyond the Second Opinion: Credit Rating Agencies', *The Economist* (London), 30 March 1991, 80.

[67] See *Proposed SEC Rules*, above n 13, 36 217. According to the SEC, the magnitude of the downgrades was 'striking' and 'unprecedented'. The average downgrade was around seven notches whereas the previous average, prior to 2007, was three to four notches. See also Henry A Waxman, Statement to Committee on Oversight and Government Reform, US House of Representatives, *Credit Rating Agencies and the Financial Crisis*, 22 October 2008, 1. According to Waxman: 'S&P … downgraded more than two-thirds of its investment-grade [structured finance] ratings. Moody's had to downgrade over 5000 mortgage-backed securities.'

[68] Hunt, above n 2, 161.

[69] Ibid 164–73.

[70] Ibid.

III RATING THE RATERS

A *Rating Shopping*

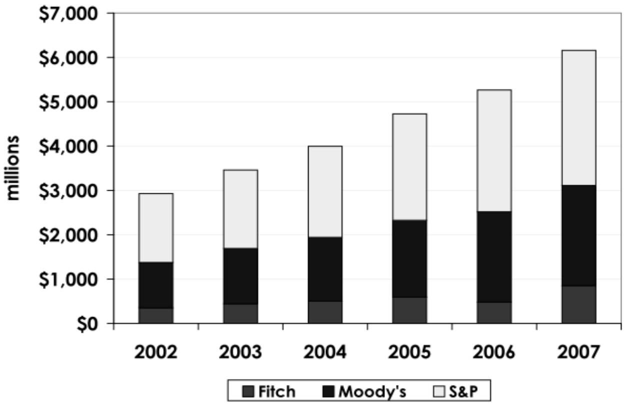

Figure 1: Revenue of Big 3 Credit Rating Agencies: 2002–07[71]

As foreshadowed, aside from the questions of reliance and rating methodologies, the overall conduct of the CRAs' rating business and ancillary activities has also come under close scrutiny. In relation to the rating practices, a number of authors, including John Hunt, Joseph Mason and Joshua Rosner, Timothy Riddiough and Risharng Chiang, Jerome Fons, as well as John Coffee, have separately argued that the CRAs were not merely assuming a passive credit quality certification role but that they have, in fact, actively engaged in the process of structuring[72] and expediting the issuance of securities.[73] This 'issuer-underwriter' argument is essentially twofold. First, it suggests not only that

[71] Committee on Oversight and Government Reform, US House of Representatives, *Revenue of Big 3 Credit Rating Agencies: 2002–2007* (2008) <http://oversight.house.gov/story.asp?ID=2250>.

[72] Joseph R Mason and Joshua Rosner, 'Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions' (Working Paper, 3 May 2007) 13 <http://ssrn.com/abstract=1027475>; Timothy J Riddiough and Risharng Chiang, *Commercial Mortgage-Backed Securities: An Exploration into Agency, Innovation, Information, and Learning in Financial Markets* (2004) 1 <http://www.fin.nchu.edu.tw/03_research/fin2003/Commercial%20Mortgage-backed%20Securities.pdf>; CESR, *The Role of the Credit Rating Agencies in Structured Finance*, above n 25, 9; Hunt, above n 2, 176–8. According to Riddiough and Chiang, 'the rating agency actively controls security architecture and [is] instrumental in determining product design standards.' See also Committee on the Global Financial System, above n 10, 2:

> deal origination … involves obtaining implicit structuring advice by the rating agencies, at least to the extent that arrangers use rating agency models to pre-structure deals and subsequently engage in an iterative dialogue with the agencies in order to finalise these structures.

The Committee further stated (at 26):

> in contrast to the truly ancillary nature of the consulting services that were provided by a number of auditors, the assessment of transactions' structural features is an integral part of the process of rating structured finance tranches.

[73] Mason and Rosner, above n 72, 13; Jerome S Fons, 'Rating Competition and Structured Finance' (2008) 14(3) *Journal of Structured Finance* 7, 11; Coffee, above n 19, 78–80.

the rating methodology was substantively flawed, but also that the rating standards have been sacrificed in order to expedite the structured finance transactions.

Secondly, the argument assumes that the CRAs and the issuers engaged in a competitive process, which has been characterised as 'rating shopping'.[74] Fons explains the process by pointing out that both the CRAs and the issuers had enormous financial incentives to expedite the structured finance transactions, which led the CRAs to compete on standards of credit support.[75] As a consequence, the CRA 'most willing to assign a low level of support to a given transaction [was] most likely to receive the mandate to rate it.'[76] Throughout the process, according to Fons, the investment banks wielded 'tremendous power and play[ed] the ratings agencies off of one another.'[77] The CRAs further aggravated this practice by providing the issuers with free pre-rating assessments.[78]

In a confidential memorandum tendered in evidence to the US House of Representatives Committee on Oversight and Government Reform ('US House Committee'), Moody's Chief Executive Officer indicated that the agencies may have suffered from an overconfidence syndrome,[79] and that they often acted under considerable pressure from institutional investors not to downgrade the ratings.[80] His comments are particularly significant as they indicate an awareness that:

> Unchecked, competition on this basis can place the entire financial system at risk. It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want rating downgrades; short-sighted bankers labor short-sightedly to game the rating agencies for a few extra basis points on execution.[81]

[74] Fons, 'Rating Competition and Structured Finance', above n 73, 11.

[75] Ibid. Fons states that 'structured finance is perhaps the largest single product line for the major ratings agencies, representing 40 per cent or more of total revenues.' See also Waxman, above n 67, 1:

> total revenues for the three firms doubled from $3 billion in 2002 to over $6 billion in 2007. At Moody's, profits quadrupled between 2000 and 2007. In fact, Moody's had the highest profit margin of any company in the S&P 500 for five years in a row.

[76] Fons, 'Rating Competition and Structured Finance', above n 73, 11.

[77] Ibid. See also Raymond McDaniel, 'Credit Policy Issues at Moody's Suggested by the Subprime/Liquidity Crisis' (21 October 2007) [9] <http://oversight.house.gov/documents/20081022111050.pdf>: 'The [CDO ratings] are simply the latest instance of trying to hit perfect rating pitch in a noisy market place of competing interests.'

[78] Lubochinsky and Raingeard, above n 49, 5; *IOSCO Final Report*, above n 6, 14. See also Mason and Rosner, above n 72, 13.

[79] McDaniel, above n 77, [12]–[13]: 'a certain complacency about ratings quality is inevitable after a prolonged period of rating success. … Organizations often interpret past successes as evidencing their competence and the adequacy of their procedures rather than a run of good luck.'

[80] Ibid [10].

[81] Ibid [5].

Whilst the above arguments would support the conclusion that the CRAs have been the 'willing victims' at the hands of the investment bankers and investors,[82] there is also evidence to suggest that the transparency, quality and integrity of the CRAs' other practices and processes was substantially lowered in order to support the extraordinary growth of their structured finance operations.[83] The SEC recently conducted an examination into the CRAs' business operations and analysed their internal governance systems and rating practices under the inspection powers provided by the *CRA Reform Act*.[84] As noted above, the Act is significant because it provided the SEC, for the first time, with a limited authority to examine and enquire into the reporting and record-keeping practices of the CRAs.[85]

B *SEC Examination*

The SEC found numerous procedural and organisational shortcomings. The first, as noted above, was the lack of due diligence performed on the information received from the issuers.[86] The CRAs neither verified the integrity of the data provided nor did they seek representations from issuers that due diligence was performed.[87] Another deficiency was their insufficient staffing levels and their struggle to cope with the enormous growth of structured finance ratings.[88] There was also evidence suggestive of an increase in less conservative rating practices and of general staff awareness that the models did not capture full transactional risk.[89] Furthermore, the SEC found that significant aspects of the ratings processes and the methodologies used to rate CDOs were not always disclosed.[90] For example, one CRA did not disclose the reduction in its model's raw loss numbers and its use of matrices to adjust model outputs for second lien loans.[91]

Secondly, there were significant concerns noted in relation to the CRAs' internal governance and surveillance procedures. For example, individual 'out-of-model' adjustments were made on an ad hoc basis, whilst in many cases the CRAs did not have any documentation explaining the rationale for such

[82] Ibid [10]. According to McDaniel, '[a]nalysts and [managing directors] are continually "pitched" by bankers, issuers, investors — all with reasonable arguments — whose views can colour credit judgment, sometimes improving it, other times degrading it'.

[83] Moody's Investors Service, 'Final Transcript: Managing Director's Town Hall Meeting' (10 September 2007) 63 <http://oversight.house.gov/story.asp?ID=2250>. McDaniel states:

> What happened in '04 and '05 with respect to subordinated tranches is that our competition, Fitch and S&P, went nuts. Everything was investment grade. … We said we're not rating it. This stuff isn't investment grade. No one cared because the machine just kept going.

[84] *SEC Examination*, above n 22.

[85] *CRA Reform Act* § 5, amending 15 USC § 78q(a)(1) (2006).

[86] *SEC Examination*, above n 22, 9.

[87] Ibid 18.

[88] Ibid 10.

[89] Ibid 12. The SEC lists a number of examples of staff awareness of model deficiencies. For instance '[o]ne analyst expressed concern that her firm's model did not capture "half" of the deal's risk, and that "it could be structured by cows and [the CRA] would rate it."'

[90] Ibid 13.

[91] Ibid.

adjustments.[92] This made it 'impossible to identify the factors [leading] to the decision to deviate from the model.'[93] Furthermore, the SEC noted that none of the CRAs had specific written procedures for rating structured finance instruments or for identifying or addressing errors in their models and methodologies.[94] There was also a notable lack of documentation on the rating committees' actions and decisions, with the result that a quarter of committee reviews of structured finance ratings routinely failed to disclose the chairperson's identity.[95] According to the SEC, the deficiencies not only highlighted a lack of business transparency in general, but also greatly impeded the effectiveness of auditors conducting reviews of the CRAs' activities.[96]

In relation to the CRAs' surveillance, the SEC observed that the procedures have been even less robust than their initial rating processes.[97] There was a lack of personnel and model information to reassess existing ratings using new and improved assumptions.[98] Commenting on this aspect of S&P's surveillance centre, Raiter testified before the US House Committee that the management had decided to turn it into a profit centre instead of equipping it to become a critical part of their commitment to keep investors informed of the historical performances of the securities.[99] According to Raiter, the surveillance teams did not re-run updated models on rated structured securities out of a fear that the ratings performance would prove too volatile when compared to the traditional triple-A rated bonds.[100] According to him, this would have alerted the investors to the possibility that not all triple-A ratings were the same.[101]

C *Inherent Conflicts of Interest*

The third area of operational concern identified by the SEC was the CRAs' management of conflicts of interest, despite the fact that they had existing internal protocols and procedures governing this issue.[102] One key concern with such policies in general is the need to separate the analytical side from the trading side of the business in order to prevent considerations of business and staff remuneration impacting on the objectivity of the analytical criteria.[103]

92 Ibid 14.
93 Ibid.
94 Ibid 16–17.
95 Ibid 19–20.
96 Ibid 19.
97 Ibid 21.
98 Ibid.
99 See *Transcript of US House Committee*, above n 12, 40.
100 Ibid 40–1.
101 Ibid.
102 *SEC Examination*, above n 22, 23.
103 See, eg, Corporate Law Economic Reform Program, *Corporate Disclosure: Strengthening the Financial Reporting Framework*, Paper No 9 (2002) pt 7.2 ('CLERP 9'):

> The way analysts are compensated for the services they provide can create pressure on their independence and objectivity. A research analyst's salary or bonus might be linked to the profitability of other corporate and trading services, such as investment banking services. This might give the analyst an incentive to provide positive research reports and recommendations,

Having observed the CRAs' practices, the SEC concluded that the conflict management policies 'still allowed key participants in the rating process to participate in fee discussions' and deal structuring.[104] For example, rating analysts were aware of the specific business agendas in securing the rating deals, including fee schedules and actual negotiated fees.[105] In addition, there was evidence to suggest that analysts were also aware of the market share considerations and competitors' rating practices, including the credit support levels required for competition on the rating deals.[106]

The second concern noted by the SEC was that whilst the conflicts were inherent in the issuer-pays business model in general, they appeared 'particularly inherent' in the structured finance ratings process.[107] This is a concern also expressed by the Committee of European Securities Regulators ('CESR'), which noted that CRAs may 'favour business volume instead of rigorousness and independence and hence [may] "overrate" transactions in order to maintain a profitable flow of business from arrangers.'[108] Both the CESR and the SEC have also highlighted the excessive concentration of arrangers, with the SEC noting that 12 arrangers accounted for 80 per cent of all structured finance deals.[109] As mentioned above,[110] the investment banks wielded considerable power of persuasion, which contributed to the undesirable practices of pre-rating assessments, rating shopping, as well as 'churning'.[111] The SEC also noted that the issuers enjoyed the flexibility of readjusting the structured finance products and subsequently obtaining the desired rating.[112]

The third concern in relation to the management of conflicts of interest relates to the CRAs' provision of ancillary services and the practice of issuing rating downgrades as a disciplining mechanism. Partnoy as well as Mason and Rosner have separately identified a number of ancillary services offered by CRAs, including free pre-rating assessments, unsolicited assessments and corporate consulting services, which all have the potential to conflict with their rating objectivity.[113] One particularly problematic practice is the CRAs' provision of

which may foster the client company's continued relationship with the analyst's firm and increase the analyst's compensation.

104 *SEC Examination*, above n 22, 23–4. See also CESR, *The Role of the Credit Rating Agencies in Structured Finance*, above n 25, 9, 13.

105 *SEC Examination*, above n 22, 24–5.

106 Ibid 25–6.

107 Ibid 31.

108 CESR, *The Role of the Credit Rating Agencies in Structured Finance*, above n 25, 9.

109 *SEC Examination*, above n 22, 32. See also ibid 13.

110 See above Part III(A).

111 *SEC Examination*, above n 22, 31–2. The term 'churning' refers to the situation where the issuer's staff is eager to achieve a large volume of transactions to get bonuses and commissions. They put pressure on the rating staff which affects CRAs' rating performance.

112 Ibid 8, 31. See also CESR, *The Role of the Credit Rating Agencies in Structured Finance*, above n 25, 9, 21; Committee on the Global Financial System, above n 10, 26.

113 Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 68–71; Mason and Rosner, above n 72, 19.

free rating previews which allows the issuers to engage in rating shopping.[114] In addition, CRAs often provide ancillary and consulting services to assist businesses in achieving high post-transaction ratings.[115]

According to Partnoy, some of the ancillary services at first appear reminiscent of the auditing firms' practices of providing consulting, technology and business structuring solutions during the Enron-era, when a number of corrupt firms issued favourable audit reports in order to obtain ancillary service fees.[116] However, Partnoy also highlights the more serious nature of CRAs' conflicts of interest, in that the former conflicts only had the effect of 'pulling' the issuers to obtain new business, whereas the rating downgrades have also had the intention of 'pushing', or rather disciplining, the issuers for not purchasing their rating or advisory services.[117] Partnoy and the US House Committee have separately cited a number of well-documented cases where the CRAs downgraded ratings as a means of 'racketeering' issuers who did not wish to use their services.[118]

Based on the above discussion, therefore, a number of important conclusions can be made about the nature and transparency of CRAs' business model and operations. First, there are significant conflicts of interest inherent in the issuer-pays business model, particularly in structured finance operations. Secondly, there are significant concerns about the integrity and transparency of CRAs' internal governance procedures, surveillance, as well as staff independence. Thirdly, it is necessary to better define, and possibly restrict, the role of CRAs in the provision of deal-structuring and ancillary services. In addition, some specific measures may also be required to address the practices of rating shopping and rating downgrades.

The following Part analyses the conceptual adequacy of the issuer-pays business model and outlines the recent regulatory developments in the US and the EU addressing the operational problems discussed in this Part. It will also be argued that an efficient inspection, surveillance and supervision regime is essential to maintaining the credibility of the issuer-pays business model and CRAs' reputation.

[114] Coffee, above n 19, 16. See also Fons, 'Rating Competition and Structured Finance', above n 73, 11.

[115] Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 70. See also CESR, *The Role of the Credit Rating Agencies in Structured Finance*, above n 25, 12.

[116] Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 70; Stephen J Choi, 'A Framework for the Regulation of Securities Market Intermediaries' (2004) 1 *Berkeley Business Law Journal* 45, 51–2. Choi refers to Enron-type conflicts involving the auditing firm Arthur Andersen: at 52–3.

[117] Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 72.

[118] Ibid 71–2. Partnoy discusses one case when Moody's issued a 'negative outlook' on the bonds of a former client, a school district, which hired S&P and Fitch for the issue. Several buyers immediately cancelled their orders and the school district was forced to re-price the bonds and pay a higher rate. See also *Transcript of US House Committee*, above n 12, 65–7, in which Sean Egan referred to an adverse unsolicited rating issued by Moody's when the German insurer Hannover Re refused to be rated by them. A Committee member characterised the practice as 'a form of a racket': at 65 (Dennis Kucinich).

IV The Regulators' Perspective

A *The Operational Model*

Proponents of the investor-pays model have argued that the model is conceptually superior to the issuer-pays model and that it may be more effective in protecting the interests of investors.[119] Jerome Fons and Sean Egan have highlighted the fact that the investor-pays model worked well after it was initially devised by John Moody and utilised by the three main CRAs until the 1970s.[120] In support of the investor-pays model, Egan cites a number of recent examples which suggest that his agency, Egan-Jones Ratings, which is funded exclusively by investors, has had a track-record superior to the main three CRAs during the recent crises.[121]

Fons, on the other hand, is not persuaded that a CRA market based on the investor-pays model would be superior, for a number of reasons. First, he points to the 'free-rider' problem, which initially emerged with the advent of the photocopier, allowing non-paying investors to benefit from easy access to the rating lists.[122] Secondly, according to Fons, the investor base per bond is simply too small to support adequate technical analysis, which was one of the main reasons why the CRAs began charging the issuers in the first place.[123] Thirdly, the investor-pays model arguably involves conflicts of interest because the paying investors would prefer to have lower ratings on the bonds they purchase.[124] The fourth reason, which is separately advanced by Jerome Fons and Deven Sharma, is that an investor-funded model would possibly restrict access to a select group of investors and undermine the current status of credit ratings as 'public goods'.[125] Sharma particularly highlights the fact that the CRAs collectively analyse and publish millions of public ratings to the market free of charge, most of which are subject to market scrutiny and reaction in real-time.[126]

On balance, the arguments in favour of the issuer-pays model appear sufficiently plausible from a practical point of view: the CRAs not only provide an important public service, but they also have the human and technical resources to perform that service. Therefore, it would be a financial, technical and logistical challenge for regulators to contemplate a competing market model, such as a 'regulator agency' or an alternative financing structure which does not take into

119 Egan, above n 2, 1.

120 Ibid 3; Fons, Testimony to Committee on Oversight and Government Reform, above n 16, 3–4. See also Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 63. Fons and Partnoy point out that the agency John Moody founded was an investors' service, rather than an issuers' service.

121 See *Transcript of US House Committee*, above n 12, 28. According to Egan, Egan-Jones Ratings downgraded Enron Corporation several months before the competitors and WorldCom nine months before.

122 Fons, 'Rating Competition and Structured Finance', above n 73, 12.

123 Ibid.

124 Deven Sharma, Testimony to Committee on Oversight and Government Reform, US House of Representatives, *Credit Rating Agencies and the Financial Crisis*, 22 October 2008, 12.

125 Fons, 'Rating Competition and Structured Finance', above n 73, 12; ibid 11.

126 Sharma, above n 124, 11.

account the CRAs' market dominance and the resources required to perform their current function.[127]As a result, the arguments in favour of retaining the issuer-pays model are sufficiently compelling, making it unlikely that the current model will be challenged for some time.

B *The Regulators' Dilemma*

Given the oligopolistic nature of the CRA market and the lack of realistic and viable model alternatives, it follows that regulators must address the questions of competition and the conflicts inherent in the issuer-pays business model more effectively. Stephen Choi analysed a number of institution-specific laws that were introduced in the US in the wake of the Enron scandal and outlined several structural options at regulators' disposal. These options range from the most prescriptive merit-based regulation, to a regulator-tailored set of options, to the least intrusive option of self-regulation.[128] In deciding on the level of intervention, according to Choi, regulators need to make a number of calculated trade-offs between the societal costs of regulation and failing the market.[129] On the one hand, regulators can simply mandate behaviour and prohibit all conflicts of interest confronting the financial intermediary. However, it must also take into account the counter-balancing effects. For example, lack of funding may result in the reduction of the amount of research and information available to the market.[130] On the other hand, a complete absence or weak forms of regulation may result in an undesirable misallocation of resources or even market failures.[131] This was arguably the case in the self-regulation model based on the IOSCO's *Code of Conduct Fundamentals for Credit Rating Agencies* ('*IOSCO Code*').[132]

Choi further argues that the appropriate level of intervention depends on the extent of the market failure which initiated the need for regulation, as well as the market's own potential incentives to correct that failure. Accordingly, where the market failure is deeply rooted and there are no market-based alternatives, more interventionist regulation may be justified.[133] Against these criteria, it can be argued that the operational model and the oligopolistic nature of the CRA market did not provide sufficient incentives on the part of the CRAs to correct their

127 See Fons, 'Rating Competition and Structured Finance', above n 73, 12–13. Fons also discusses a theoretical 'Mutual Rating Organization' funded by all industry participants. However, he acknowledges the market, institutional and regulatory constraints in establishing such a structure.

128 Choi, above n 116, 70–1.

129 Ibid 70.

130 Ibid 49, 51.

131 Ibid 50.

132 *IOSCO Final Report*, above n 6, annex A ('*IOSCO Code*'), which was preceded by IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies* (2004). See also CESR, *CESR's Second Report to the European Commission on the Compliance of Credit Rating Agencies with the* IOSCO Code *and the Role of Credit Rating Agencies in Structured Finance* (2008). The CESR provides a long list of areas where the CRAs did not comply with the *IOSCO Code*. They conclude that '[t]his non-compliance, even though there are explanations, indicates that some of the issues which the *IOSCO Code* is intended to address, are not being managed through the CRAs Codes in a manner that matches the *IOSCO Code* provisions exactly': at 51.

133 Choi, above n 116, 71, 75.

behaviour during the recent crisis. Indeed, as noted above,[134] even the significant reputational capital acquired by the CRAs over many decades was not, on its own, a sufficient market-based incentive against corrupt behaviour. Furthermore, following the suggested framework, the CRAs' role in the market failure appeared to be deeply rooted in the conflicts of interest inherent in the issuer-pays business model, which prompted Partnoy to characterise their role in the structured finance transactions as being that of the 'gateopeners'.[135]

Therefore, based on the above criteria, the regulators would be sufficiently justified in considering more interventionist forms of regulation, which would typically involve external supervision and enforcement mechanisms, but which may also involve alternative mechanisms for CRAs to bond their credibility.[136] For example, the *Sarbanes-Oxley Act of 2002* introduced the Oversight Board for the auditing profession, which is co-supervised by the SEC,[137] but which also contains elements of self-regulation and relies on the expertise of industry members. This aspect of 'supervised self-regulation' may be desirable to avoid the problems of stifling innovation or overly prescriptive regulation caused by the regulators' own overconfidence.

Secondly, regulators may also consider utilising variants of other gatekeeper principles introduced during the Enron-era reforms which have proved successful. The *Sarbanes-Oxley Act* is also interesting in this context because it prohibited auditing businesses from providing ancillary services and introduced more intrusive internal governance measures, which were designed to improve transparency and ensure greater auditor independence.[138] Furthermore, the *Sarbanes-Oxley Act* required the auditing firms' partners to rotate regularly to avoid the creation of clientelistic relationships with the issuers,[139] which had the potential to lead to erosion in auditing standards. To this end, the *Sarbanes-Oxley Act* bolstered the position of independent directors by requiring firms to have them involved in the day-to-day management and oversight of the business.[140] These structural measures have been generally well received because of the 'significant benefits associated with the control identification, documentation, and testing process.'[141]

Notably, the internal governance and operational control mechanisms recently adopted by the European Commission appear to be moving in this general

134 See above Part II(D).

135 Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers', above n 2, 60.

136 See Choi, above n 116, 72–3.

137 Pub L No 107-204, § 101, 116 Stat 745, 750–3 (2002), inserting 15 USC § 7211 (2006). See also ibid 73–4.

138 Pub L No 107-204, § 201, 116 Stat 745, 771 (2002), inserting 15 USC § 78j-1(g) (2006). See generally Choi, above n 116, 60–3.

139 Pub L No 107-204, § 203, 116 Stat 745, 773 (2002), inserting 15 USC § 78j-1(j) (2006).

140 Pub L No 107-204, §§ 301, 404, 116 Stat 745, 775, 789 (2002), inserting 15 USC §§ 78j-1(j), 7262 (2006).

141 Larry E Rittenberg and Patricia K Miller, *Sarbanes-Oxley Section 404 Work: Looking at the Benefits* (2005) 2. The study was conducted on behalf of the American Institute of Internal Auditors Research Foundation. Rittenberg and Miller found general improvements in audit committees and in senior management engagement in financial reporting and controls: at 2, 10.

direction.[142] The *EU Proposal* will require CRAs to establish an internal 'supervisory board' and to have at least three independent directors serving on the board.[143] The directors on the Supervisory Board will be appointed for a single term of office of up to five years, whilst a majority of them will be required to have sufficient expertise in financial services.[144] Furthermore, the independent directors will also have the task of monitoring the effectiveness of their internal quality control systems and ensuring that there are no conflicts of interest.[145]

Another important Enron-era set of principles was introduced by the Spitzer Settlement, which provided a more transparent analyst funding regime by mandating the issuers to contract with a number of independent research firms and imposing internal business separation measures designed to separate research analysts from the trading areas.[146] The main three CRAs have recently reached an agreement with the New York State Attorney-General Andrew Cuomo ('Cuomo Settlement'), which may have been inspired by some of the Spitzer Settlement measures. The Cuomo Settlement aims to regulate how CRAs are compensated by introducing a 'fee-for-service' structure in order to curb the practice of free pre-ratings and ultimately that of rating shopping.[147] The CRAs have also undertaken to require from the issuers 'due diligence data on loan pools for review prior to the issuance of ratings.'[148]

C *The SEC and European Commission Rules*

In addition to the self-regulation measures introduced under the Cuomo Settlement, a number of important new legislative proposals have been put forward by the SEC and the European Commission which are designed to address the issues of conflicts of interest and other operational shortcomings discussed in Part II. Specifically, the SEC has introduced new rules to prohibit specific conflicts of interest unless CRAs can establish, maintain and enforce written policies to address and manage those conflicts.[149] Some of the specific manageable conflicts include '[b]eing paid by issuers or underwriters to determine credit

142 See *EU Proposal*, above n 56.
143 Ibid art 5, annex 1 sections A(1)–(2).
144 Ibid annex 1 section A(2).
145 Ibid. The relevant passage provides that:

> In addition to the overall responsibility of the board, the independent members of [the] administrative or supervisory board shall have the specific task of monitoring the development of the credit rating policy, the effectiveness of the internal quality control system of the credit rating agency on the credit rating process to ensure that there are no conflicts of interest and the compliance and governance processes including the efficiency of the review function referred to in point 7 of this Section.

146 Eliot Spitzer, 'SEC, NY Attorney-General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices' (Press Release, 20 December 2002). See generally Choi, above n 116, 66–7.
147 Andrew M Cuomo, 'Attorney-General Cuomo Announces Landmark Reform Agreements with the Nation's Three Principal Credit Rating Agencies' (Press Release, 5 June 2008).
148 Ibid.
149 *Proposed SEC Rules*, above n 13, 36 218–19, amending 17 CFR § 240.17g-5(b) (2008).

ratings with respect to securities or money market instruments they issue or underwrite', '[b]eing paid for services in addition to determining credit ratings', being paid by persons who may be affected by the credit rating, as well as '[a]llowing persons within the [CRAs] to directly own securities … [in] … issuers'.[150]

Following its 2008 examination, the SEC has also proposed to prohibit CRAs from issuing ratings on structured products unless they disclose information about the underlying pools of assets.[151] According to the SEC, the proposed amendments would require the disclosure of information provided by the 'issuer, underwriter, sponsor, depositor, or trustee',[152] which would allow market participants to analyse the instrument and verify the accuracy of the data. In addition, the proposed rules would require enhanced disclosures as to whether and how information about verification performed on the underlying assets was relied on in determining the credit rating.[153]

The second notable feature of the SEC's *Proposed Rules for Nationally Recognized Statistical Rating Organizations* ('*Proposed SEC Rules*') regarding conflicts of interest is that some conflicts are deemed to be unmanageable and are prohibited outright. The current SEC rules prohibit four types of conflicts: (1) issuing a rating to issuers who accounted for 10 per cent or more of the total net revenue of the CRA in the previous year; (2) issuing a rating where a participating analyst has a direct interest in the issuer; (3) issuing a rating to a person associated with the CRA; or (4) issuing a rating where a CRA analyst is an officer of the rated entity.[154] In addition to these, the SEC has proposed further specific prohibitions targeting the structured finance business operations that have the potential to impair the objectivity and quality of the rating process. For example, the proposed rules seek to prohibit credit analysts from making recommendations to issuers of structured finance products in regard to obtaining a desired credit rating during the rating process,[155] as well as to prohibit analysts from participating in fee discussions or receiving gifts from the issuer.[156] In view

150 17 CFR §§ 240.17g-5(b)(1), (3)–(6) (2008). Other manageable conflicts include non-arms-length associations with issuers, as well as ratings of broker-dealers who are engaged in the business of underwriting securities: see §§ 240.17g-5(b)(1), (7)–(9) (2008).

151 See *Proposed SEC Rules*, above n 13, 36 219, amending 17 CFR § 240.17g-5(a) (2008).

152 *Proposed SEC Rules*, above n 13, 36 219–20, amending 17 CFR § 240.17g-5(a) (2008). According to the SEC, this requirement would include information used in rating and surveillance about the assets underlying the security and the legal structure, but would exclude specific information about the underlying loan pool data as well as certain communications between the CRAs and the issuers.

153 *Proposed SEC Rules*, above n 13, 36 233, amending the instructions for Exhibit 2 to Form NRSRO (the form prescribed by 17 CFR § 249b.300 (2008) to be used in an initial application for registration as an NRSRO), thereby altering the application process for registration under 15 USC § 78o-7(a)(1)(B)(ii) (2006). The SEC is proposing to require that both an applicant and an existing NRSRO provide this information in their description of procedures and methodologies in Exhibit 2.

154 17 CFR §§ 240.17g-5(c)(1)–(4) (2008).

155 See *Proposed SEC Rules*, above n 13, 36 226, amending 17 CFR § 240.17g-5(c) (2008).

156 *Proposed SEC Rules*, above n 13, 36 227, amending 17 CFR § 240.17g-5(c) (2008). For similar corresponding provisions relating to employees, see *EU Proposal*, above n 56, art 6, annex I section C(4).

of the identified problems, it can be said that most of these measures are generally adequate, however it is unclear why the funding threshold is considered to be an unmanageable conflict. The corresponding *EU Proposal* rule is arguably more logical. Recognising that an outright prohibition could 'penalize small CRAs and hinder the development of competition',[157] it only requires CRAs to disclose their main revenue sources.[158]

Thirdly, the SEC has proposed a series of new measures to address the concerns in relation to the CRAs' business records and disclosure. The new rules would require CRAs to keep records of all internal and external communications which relate to initiating, monitoring, determining, maintaining, changing or withdrawing a credit rating,[159] as well as to publish full historical records of all rating actions and out-of-model deviations.[160] Such measures are clearly adequate as they are designed to improve CRAs' internal business processes and allow the market and the regulators to track and verify the product rating history.

In addition to the record-keeping requirements, the SEC and the European Commission have separately proposed special rating rules requiring CRAs to use different symbols in order to differentiate ratings for structured finance products.[161] Alternatively, the rules will allow CRAs to provide a report describing how the methodologies and credit risk characteristics of those products differ from the traditional types of rated instruments.[162] The proposals thus seek to address the situation where certain investors have assumed that the risk characteristics for structured finance products are the same as those for traditional bond ratings. In this regard, the *EU Proposal* goes even further in that it will also require differentiated symbols for unsolicited ratings, recognising their potential unreliability due to the lack of inside information from the issuer and their potential for misuse.[163]

It can be observed that the *EU Proposal* contains a number of distinctive structural features when compared to the *Proposed SEC Rules*. For example, CRAs will not be allowed to provide consultancy or advisory services, for it has been recognised by the European Commission that this practice may result in a conflict of interest.[164] Secondly, the *EU Proposal* will require that the methodologies and assumptions used in the ratings process must be kept in a centralised public repository maintained by the CESR.[165] Furthermore, as noted above, the *EU Proposal* will require CRAs to create an internal 'supervisory board' to

[157] Lubochinsky and Raingeard, above n 49, 15.
[158] *EU Proposal*, above n 56, art 9(3), annex I section E(II)(2).
[159] See *Proposed SEC Rules*, above n 13, 36 231, amending 17 CFR § 240.17g-2(b)(7) (2008).
[160] See *Proposed SEC Rules*, above n 13, 36 228–30, amending 17 CFR §§ 240.17g-2(a)(2), (a)(8), (d) (2008).
[161] *Proposed SEC Rules*, above n 13, 36 235, inserting 17 CFR § 240.17g-7 (2008); *EU Proposal*, above n 56, art 8(3).
[162] *Proposed SEC Rules*, above n 13, 36 235.
[163] *EU Proposal*, above n 56, art 8(5).
[164] Ibid art 5(2), annex I section B(4). Notably, the Commission made a distinction between advisory and ancillary services. CRAs are allowed to provide ancillary services, which must be defined and disclosed. For the requirements relating to disclosure, see art 9(1), annex I section E(I)(2).
[165] Ibid art 9(2).

review the quality of the ratings and ensure verifiable business transparency.[166] In addition, the *EU Proposal* will also mandate periodic rotation of CRAs' analytical staff in order to minimise the potential for conflicts of interest.[167]

Apart from the highlighted distinguishing features, the *EU Proposal* contemplates broadly similar measures to the *Proposed SEC Rules* to ensure that ratings are not affected by conflicts of interest, that CRAs maintain the high quality of the rating methodologies, and that CRAs and their staff act in a transparent manner.[168] To improve transparency, CRAs will be required to complete and publish an annual 'transparency report' containing detailed information about their internal quality control systems, record-keeping policies and rotation policies for management and analytical staff.[169] They will also be required to apply and disclose appropriate internal policies and procedures to insulate analysts from conflicts of interest, and to ensure that their compensation is determined solely by the quality and integrity of their work.[170] Finally, in relation to structured finance rating processes, the *EU Proposal* introduces almost identical measures to the *Proposed SEC Rules*, such as the requirement that CRAs must disclose the extent of due diligence performed on underlying securities.[171]

D *External Enforcement and Supervision*

At this point, however, it is important to point out that the CRAs' failure was not principally attributable to a lack of adequate governance principles or rules about rating procedures, staff independence or business transparency. The *IOSCO Code*, which has been adopted by most CRAs, sets out in detail the desired standards for the rating methodologies,[172] monitoring and updating,[173]

[166] Ibid art 5, annex I section A.

[167] Ibid arts 6(4)–(5). Note that this requirement only applies to CRAs who have 50 or more analysts.

[168] For example, art 5 seeks to ensure the independence of ratings by requiring CRAs to prevent conflicts of interest or manage them adequately where they are unavoidable. Furthermore, annex I section B contains operational measures, section C contains rules about employee independence and section D contains rules on the representation of credit ratings.

[169] Ibid art 10, annex I section E(III).

[170] Ibid art 6, annex I section C, which provide an exhaustive list of rules about analyst independence. These are substantially similar to those proposed by the SEC: see *Proposed SEC Rules*, above n 13, 36 226–8.

[171] Ibid art 8(2), annex I section D(II)(2).

[172] See, eg, *IOSCO Code* art 1.2: 'A CRA should use rating methodologies that are rigorous, systematic, and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience.' Further, art 1.7-3 provides:

> A CRA should assess whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially. In cases where the complexity or structure of a new type of structured product or the lack of robust data about the assets underlying the structured product raise serious questions as to whether the CRA can determine a credible credit rating for the security, [the] CRA should refrain from issuing a credit rating.

[173] Ibid art 1.9: 'A CRA should ensure that adequate personnel and financial resources are allocated to monitoring and updating its ratings.'

integrity of the rating process,[174] staff independence,[175] avoidance of conflicts of interest,[176] ratings transparency,[177] and so on. In fact, as far as the operational principles are concerned, the European Commission regarded the *IOSCO Code* as an important benchmark which (along with the reports of the Financial Stability Forum and the Committee on the Global Financial System) 'to a large extent inspired' the *EU Proposal*.[178] However, in the European Commission's view, the *IOSCO Code* did 'not appear to offer an adequate, reliable solution to the *structural deficiencies of the business*.'[179] The most important reason for this, according to the European Commission, is that the *IOSCO Code* provided no robust enforcement mechanism as it only invited CRAs to explain the reasons if they did not comply with the *IOSCO Code*.[180]

Indeed, it follows from the above discussion that a robust inspection, supervision and enforcement regime is essential to maintaining the credibility of CRAs and the issuer-pays business model. The *CRA Reform Act* and the *EU Proposal* have each created frameworks for registration and supervision which require CRAs to provide extensive information about their businesses and rating methodologies, as well as to submit to the inspection, supervision and enforcement powers of the regulator.

The *EU Proposal* aims to address the supervision issues by delegating regulatory oversight to the home state Competent Authorities ('CAs'), who will be required to work in close cooperation with other states as well as with the CESR. The CESR will provide advice on the granting or withdrawal of the registration by the CAs and will also be involved in the registration process as the 'single entry point'.[181] The proposed inspection powers will allow the CAs the ability to

[174] Ibid art 1.13: 'A CRA's analysts should be held to high standards of integrity, and a CRA should not employ individuals with demonstrably compromised integrity.' See also art 1.14-1: '[a] CRA should prohibit its analysts from making proposals or recommendations regarding the design of structured finance products that a CRA rates.'

[175] Ibid art 2.2: 'A CRA and its analysts should use care and professional judgment to maintain both the substance and appearance of independence and objectivity.'

[176] Ibid art 2.1: 'A CRA should not forbear or refrain from taking a rating action based on the potential effect (economic, political, or otherwise) of the action on the CRA, an issuer, an investor, or other market participant.' See also art 2.4, which provides that '[t]he credit rating a CRA assigns to an issuer or security should not be affected by the existence of or potential for a business relationship between the CRA … and the issuer … or any other party'. See also art 2.5:

> A CRA should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest. A CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise. A CRA should also define what it considers, and does not consider, to be an ancillary business and why.

[177] Ibid art 3.5(d):

> Where a CRA rates a structured finance product, it should provide investors and/or subscribers (depending on the CRA's business model) with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product can understand the basis for the CRA's rating.

[178] *European Commission's Consultation Document*, above n 5, 2.

[179] *EU Proposal*, above n 56, 3 (emphasis added).

[180] Ibid. This is the so-called 'comply or explain' approach.

[181] Ibid 9, discussing arts 12–17.

carry out on-site inspections, with or without announcement, as well as to obtain access to documents, information, telephone listings or data.[182] The proposed supervisory measures are also extensive and range from prohibiting CRAs from operating in the EU, to suspending their operations, to referring matters for criminal prosecution.[183] In relation to penalties, the EU member states will be required to introduce penalties for infringements, which must be effective, proportionate and dissuasive, and must 'at least, cover cases of gross professional misconduct and lack of due diligence.'[184] All of these supervisory measures appear justified and necessary to ensure CRAs' adherence to the required standards of conduct as prescribed by the *EU Proposal*.

E *Options for Australian Regulators*

Regardless of the institutional, conceptual and contextual differences between the US and European regulatory approaches, it can be concluded that most of the measures put forward by their respective regulators appear broadly adequate to address the structural problems identified in the course of the above discussion. First, in relation to the rating methodologies, legislation must adequately address the issue of ratings transparency, as well as the rigour and consistency of the methodologies utilised by CRAs. The *APRA Guidelines* are a useful starting point, however they should be incorporated into a formal regulatory framework and their application extended beyond the realm of prudential regulation.

In relation to the internal governance issues, the introduction of suitably qualified independent directors to serve on an internal supervisory board would appear to be particularly appropriate, given that this is a relatively low-cost confidence building measure which may have a significant effect on internal governance monitoring and overall CRA reputation. Alternatively, regulators in Australia may consider an external oversight board, inspired by the *Sarbanes-Oxley Act*, in order to promote supervised self-monitoring of the CRA industry. The proposed restrictions on CRAs providing advisory services and free pre-rating assessments should also be taken into account by the Australian regulators because of their potential for market misuse. Likewise, a mandatory annual transparency report, requiring due diligence and better transparency of the structured finance rating process, may be necessary in order to assist CRAs in restoring a degree of market confidence and reputational capital lost during the recent crisis.

The Australian Securities and Investments Commission ('ASIC') currently has at its disposal extensive supervision and enforcement powers under the *Corporations Act 2001* (Cth) in relation to the conduct of Australian Financial Services Licensees.[185] However, whilst it recognises that credit ratings represent 'finan-

[182] Ibid art 20(3)(c).
[183] Ibid art 21.
[184] Ibid art 31.
[185] See, eg, *Corporations Act 2001* (Cth) s 915B, which gives ASIC the power to suspend or cancel an Australian Financial Services Licence. Sections 920A and 921A give ASIC the power to ban

cial product advice' under s 766B(1) of the *Corporations Act 2001* (Cth),[186] ASIC has specifically exempted CRAs from the requirement to hold an Australian Financial Services Licence.[187] The exemption is particularly significant in that it also exempts CRAs from certain licensee conduct obligations under s 912A of the *Corporations Act 2001* (Cth), including the requirements to 'do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly'[188] and to 'have in place adequate arrangements for the management of conflicts of interest'.[189] Where applicable, this provision also imposes obligations on the licensees to have adequate resources to provide financial services, to have in place adequate risk management systems, and to ensure that its representatives are adequately trained and competent.[190]

Notably, ASIC granted the exemption on the condition that the CRAs adhere to the *IOSCO Code* and provide ASIC with information about their credit rating business upon request.[191] There appear to be no cogent policy reasons for this exemption, as ASIC itself advised that it 'granted this interim exemption while [it] finalised [its] regulatory position on credit rating agencies under the Act'.[192] Against the above history, the wait-and-see approach by ASIC has proved to be problematic and difficult to understand, particularly because the six-year-long process of finalising its regulatory position has also coincided with a period characterised by important financial services reforms and market failures involving the CRAs.[193]

or disqualify a licensee where the licensee has not complied with licence obligations. Section 912E requires licensees to cooperate with ASIC surveillance and other checks.

[186] *Corporations Act 2001* (Cth) s 766B(1) defines 'financial product advice' as:

> a recommendation or a statement of opinion, or a report of either of those things, that:
>
> (a) is intended to influence a person or persons in making a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products; or
>
> (b) could reasonably be regarded as being intended to have such an influence.

[187] See above n 4 and accompanying text.

[188] *Corporations Act 2001* (Cth) s 912A(1)(a).

[189] *Corporations Act 2001* (Cth) s 912A(1)(aa).

[190] *Corporations Act 2001* (Cth) ss 912A(1)(d)–(j).

[191] ASIC, *Credit Rating Agencies*, Class Order No 05/1230, 31 December 2005; ASIC, 'ASIC Provides Ongoing Licensing Relief for Credit Rating Agencies' (Information Release No 05/63, 19 December 2005).

[192] ASIC, *Licensing: Credit Ratings Agencies* (Consultation Paper No 65, 2005) 3.

[193] Nick Sherry, 'Minister Welcomes Roundtable Report on Ratings Users and Accepts Regulator Update on Licensing' (Press Release, 5 June 2009). According to the release:

> In late 2008, the Government announced that ratings agencies would be required to hold an Australian Financial Services Licence (AFSL) by 1 July, 2009, and issue annual compliance reports against the International Organisation of Securities Commissions (IOSCO) *Code of Conduct*.

ASIC has requested, and the government has agreed to, a further extension of the licensing timeframe until 1 January 2010.

V CONCLUSION

One of the aims of this article was to point to a number of structural and operational deficiencies inherent in the CRAs' business model and rating methodologies. Recent events have demonstrated that the CRAs' reputational capital alone is not sufficient to protect the integrity of the CRAs' market or to ensure efficient and transparent functioning of their business operations. Prescriptive operational rules are justified and necessary in order to address the conflicts of interest which are inherent in the issuer-pays business model and particularly in the structured finance operations. To this end, it will also be necessary to introduce more intrusive inspection, internal governance and surveillance rules, as well as to provide an efficient enforcement regime. Finally, regulators will have to introduce enhanced transparency measures in order to improve the reliability of the CRAs' rating methodologies. Australian regulators should analyse and consider the specific operational measures initiated by the US and European regulators and remove the CRAs' current exemption from the requirement of holding an Australian Financial Services Licence. The article recommends that Australian regulators set up either an external oversight board inspired by the *Sarbanes-Oxley Act* or, alternatively, an internal supervisory board inspired by the *EU Proposal* as a means of providing enhanced transparency of internal governance and restoring the CRAs' reputational capital.