Regulating the Rating agencies

A dose of lessons in corporate governance and a prescription of (more) disclosure

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I. Introduction

Experts and regulators agree that the global financial crisis was caused by a confluence of regulatory and corporate governance failures.[1] The market for over-the-counter financial products was opaque, causing investors to rely on external monitors like credit rating agencies ('CRA') for assurance, due diligence, and credit risk analyses. Banks deceived,[2] pressured,[3] and sometimes colluded[4] with CRAs in order to achieve investment-grade ratings, which conferred regulatory and commercial benefits.[5] The majority of subprime mortgages underlying complex financial products, which were undeservingly conferred investment-grade status, eventually defaulted.[6] As a consequence, credit ratings were revised downwards, triggering a host of regulatory and contractual obligations which simultaneously heightened the demand for and shortened the supply of liquidity, causing the credit crunch.[7]

[1] See, eg, European Commission High Level Group on Financial Supervision in the EU Chaired by Jacques de Larosiere, *Report* (25 February 2009) <http://goo.gl/SJKPq3>. See also P M Vasudev, 'Credit Derivatives and Risk Management: Corporate Governance in the Sarbanes-Oxley World' (2009) 4 *Journal of Business Law* 331, 352; Yuliya Demyayk and Otto Van Hemert, 'Understanding the Subprime Mortgage Crisis' (2011) 24(6) *Review of Financial Studies* 1848; Amiyatosh Purnanandam, 'Originate-to-distribute Model and the Subprime Mortgage Crisis' (2011) 24(6) *Review of Financial Studies* 188.

[2] The SEC charged one such bank for deceitful behaviour under sections17(a)(2) and 17(a)(3) of the *Securities Act (1933)*15 USC §§ 77(q)(a)(2), 77(q)(a)(3) The bank eventually settled a charge brought by the SEC for US$127.5 million– see SEC, 'Mizuho to Pay $127.5 million to Settle SEC Charges of Misleading Investors in CDO' (Litigation Release No 22417, Press Release, 19 July 2012) <http://goo.gl/iqLFMH> for an online copy of the charge, go to <http://goo.gl/2EHcYg>. See also Maurice Mullard, 'The Credit Rating Agencies and Their Contribution to the Financial Crisis' (2012) 83(1) *Political Quarterly* 77, 80, 93.

[3] Steven McNamara, 'Informational Failures in Structured Finance and Dodd-Frank's "Improvements to the Regulation of Credit Rating Agencies"' (2011) 17 *Fordham Journal of Corporate and Financial* Law 666. See also Marilyn Bumberg Cane, Adam Shamir and Tomas Jodar, 'Below Investment Grade and Above the Law: A Past, Present and Future Look at the Accountability of Credit Rating Agencies' (2011) 17 *Fordham Journal of Corporate and Financial Law* 1064; Steven Scalet and Thomas F Kelly, 'The Ethics of Credit Rating Agencies: What Happened and The Way Forward' (2012) 111 *Journal of Business Ethics* 477.

[4] *Bathurst Regional Council v Local Government Financial Services Pty Ltd* (No 5) [2012] FCA 1200 ('*Bathurst Case*'). A copy of the full judgement and a summary is available online, at <http://goo.gl/EXuI11> and <http://goo.gl/s5tBgV> respectively.

[5] See generally Andrea Miglionico, 'Enhancing the Regulation of Credit Rating Agencies, In Search of a Method' (Monograph, July 2012) <http://goo.gl/VHNgvl>.

[6] Patrick Bolton, Xavier Freixas and Joel Shapiro, 'Credit Ratings Game' (Working Paper No 17412, National Bureau of Economic Research, February 2009) <http://goo.gl/0Oky1m>.

[7] For a chronology of the events leading up to and during the sub-prime crisis, see Tao Sun and Xiaojing Zhang, 'Spillovers of the US Subprime Financial Turmoil to Mainland

CRAs have been and continue to be under intense scrutiny. Litigation brought by investors[8] and regulators[9] alike reveal the amount and extent of foul play on the part of banks and CRAs leading up to the crisis. As gatekeepers and informational intermediaries in an opaque environment, they had much to answer for their roles as 'essential cogs in the wheel of financial destruction.'[10] Following this criticism, this paper examines the way CRAs are governed, with particular attention to the 'Big Three' CRAs – Moody's, Standard and Poor's, and Fitch Ratings. The accuracy and integrity of credit ratings are compromised by numerous conflicts of interest which arise within the CRA setting. Whilst these conflicts are not new, adequate redress remains pending. This paper explores the causes of these conflicts and attempts to provide some practical solutions. Internal and external governance failures of CRAs will be examined, and recent regulatory responses to these failures will be discussed, highlighting the lack of incentives (and disincentives) for CRAs to comply (for non-compliance) with good governance principles. It then turns to consider the lack of CRA accountability for credit ratings and proposes improvements to CRA methods and policies in order to safeguard the integrity of the ratings process.

II. Reformational Imperatives

This section argues that several factors make CRA reform an international priority. In summary:

1. there is systemic over-reliance on credit ratings by domestic and international laws and practices, which increased the demand of credit ratings from the Big Three;
2. regulatory reliance legitimised the use of credit ratings to indicate credit risk and quality, leading investors to trust credit ratings as a substitute for proper due diligence;
3. coupled with the ownership structure of the Big Three, the lack of legislative prescriptions and prohibitions about CRA governance and rating methods gave rise to poor corporate governance practices;
4. these practices continue because CRAs continue to abuse the flexibility of principles-based governance; and

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China and Hong Kong SAR: Evidence from Stock Markets' (IMF Working Paper WP/09/166, August 2009), 31-36 <http://goo.gl/jgZ0PE>.

[8] See, eg, *Bathurst Case* [2012] FCA 1200.

[9] See, eg, *US Securities and Exchange Commission v Mizuho Securities USA Inc* 12 CG 5550 (RA) (Abrams J) (SDNY filed 18 July 2012)

[10] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (25 February 2011) ('*Financial Crisis Inquiry*'), xxv <http://goo.gl/w602a5>.

5. CRA immunity from civil action means that the conflicts of interest which arise under the issuer-pays model remain unchecked, compromising rating accuracy in the result.

A. *Regulatory Reliance and the Regulation of Credit Ratings*

Credit ratings are an important part of business and regulation, domestically and internationally. In the USA alone, more than one hundred and fifty pieces of legislation (including subsidiary legislation) rely on credit ratings to determine the scope or limit of regulatory obligations and prescriptions.[11] For example, money market and pension funds are only allowed to purchase financial products above a certain investment grade.[12] This means that the marketability and profitability of each financial product is influenced by its credit rating, since a higher rating meant that the product can be bought by and sold to a wider class of investors.

At the supranational level, credit ratings are used in the Basel II standard in determining the capital adequacy obligations of banks.[13] Whilst the Basel II Accord does not officially have the force of law, voluntarily-subscribing banks have 'hard-wired' it by requiring counterparties to comply. Compliance with Basel II is practically a precondition.[14] The implementation of an improved capital adequacy framework in which reference to and reliance on credit ratings has been reduced, Basel III, has faced consistent delays.[15] At a firm-wide level, ratings determine an issuer's borrowing costs in the same way that they influence

[11] D Andrew Hatchett, 'SOX It to 'Em: Using Sarbanes-Oxley as a Model for Regulating Conflicts of Interest in the Credit Rating Industy' (2012) 63(2) *Alabama Law Review* 407, 409.

[12] See, eg, Lawrence J White, 'Markets: The Credit Rating Agencies', 2010 *Journal of Economic Perspectives* 24(2), 214.

[13] Basel Committee on Banking Supervision, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (November 2005), Bank for International Settlements, ('Basel II')<http://www.bis.org/publ/bcbs118.htm>. See also Carlo R W de Meijer and Michelle H W Saaf, 'The Credit Crunch and Credit Rating Agencies: Are They Really Striving Towards More Transparency?' (2008) 1(4) *Journal of Securities Law, Regulation & Compliance* 332, 323. Howell E Jackson, 'The Role of Credit Rating Agencies in the Establishment of Capital Standards for Financial Institutions in a Global Economy', in Eilís Ferran and Charles A.E. Goodhart (eds), *Regulating Financial Services and Markets in the Twenty First Century* (Hart Publishing 2001). See also Rolf H Weber and Aline Darbellay, 'The Regulatory Use of Credit Ratings in Bank Capital Requirement Regulations' (2008) 10 *Journal of Banking Regulation* 1.

[14] See, eg, Howell E Jackson, 'The Role of Credit Rating Agencies in the Establishment of Capital Standards for Financial Institutions in a Global Economy', in Eilís Ferran and Charles A.E. Goodhart (eds), *Regulating Financial Services and Markets in the Twenty First Century* (Hart Publishing 2001).

[15] Bank for International Settlements, 'Implementation of the Basel III Framework' (Press release, 14 December 2012) <http://www.bis.org/press/p121214a.htm>.

the cost and yield of sovereign debt, so issuers have a vested interest in acquiring the highest, not the most accurate, credit rating.[16]

Commercially, an AAA-grade rating exempted an issuer from collateral posting obligations for that particular issue, since it signalled quality credit and low risk, giving issuers a positional advantage in negotiations. Ratings can also trigger obligations to provide collateral in private contracts or constitute an event of default, giving counterparties the right to terminate not only the contract for that particular issue, but the plethora of contracts within that commercial relationship, demonstrably in the ISDA Master Agreement 2002[17] which is used to document over 90% of over-the-counter financial products worldwide.[18]

However, regulatory reliance on credit ratings is not necessarily a good thing. An empirical study demonstrates that increased regulatory reliance on credit ratings causes an increase in the volume of high credit ratings in general.[19] Investors have also come to view credit ratings as authoritative indicators of credit risk and quality because of its regulatory significance.[20] This misconception stems not only from the volume of laws which rely on credit ratings, but also from the NRSRO ('Nationally Recognised Statistical Rating Organizations') framework, which 'nationally recognised' credit ratings from the Big Three as the reference point for creditworthiness in national legislation, though the numbers of NRSROs have since increased.[21] Several consequences follow in the result.

Firstly, the integrity and quality of analysis of the ratings process is compromised if the increase in volume is not derived from a corresponding increase of credit

[16] Darren J Kisgen and Phillip E Strahan, 'Do Regulations Based on Credit Ratings Affect a Firm's Cost of Capital?' (2010) 23(12) *Review of Financial Studies* 4324, 4324-4325, 4327.
[17] A rating downgrade of a subsidiary or linked company can also have the same effect – this is called 'cross-default' and 'cross-acceleration' – see ss 5, 6 and 9 of the ISDA Master Agreement 2002 read with the Schedule to the Master Agreement and Credit Support Annex to the Schedule. See also Christopher C Nicholls, 'Public and Private Uses of Credit Ratings' (*Capital Markets Institute Policy Series*, August 2005) 16-20.
[18] Joanne P Braithwaite, 'OTC Derivatives, the Courts and Regulatory Reform' (2012) 7(4) *Capital Markets Law Journal* 354, 366.
[19] Josh Wolfson and Corinne Crawford, 'Lessons from the Current Financial Crisis: Should Credit Rating Agencies be Re-Structured?' (2010) 8(7) *Journal of Business & Economics Research* 85 in Christian C Opp, Marcus M Opp and Milton Harriss, 'Rating Agencies in the Face of Regulation' (2013) 108 *Journal of Financial Economics* 46, 46.
[20] Steven L Schwarcz, 'Private Ordering of Public Markets: The Rating Agency Paradox' (2002) *University of Illinois Law Review* 1, 2.
[21] T Coburn, Statement on 'Wall Street and the Financial Crisis: The Role of Credit Rating Agencies', (Washington, DC, *US Senate Permanent Subcommittee on Investigations*, 23 April 2010) 79. See also SEC, 'Amendments to Rules for Nationally Recognised Statistical Rating Organizations' (Release No 34-59342, File No S7-13-08, RIN 3235-AK14, 2 February 2009) <http://www.sec.gov/rules/final/2009/34-59342.pdf>.

quality. As history shows (Lehman, Worldcom, Enron, AIG), credit quality did not actually increase – it was simply complex, obscure, or hidden, and the ratings were inaccurate.[22] For instance, 90% of all securities rated AAA by Moody's and Standard and Poor's were downgraded to below investment-grade status after July 2007, after wide reporting of delinquencies in underlying sub-prime mortgages.[23]

Secondly, high demand for credit ratings is guaranteed, since certain grades unlock certain segments of the market, whilst regulators and investors make decisions on the basis of these ratings. Since higher credit ratings attracted less stringent regulatory obligations (particularly for capital adequacy), investors saw a high credit rating as having a 'stamp of approval' from regulators and CRAs alike, because these advantages signalled lower risk and higher credit quality. Credit ratings became a regulatory licence. These factors combined produce a morally hazardous outcome, because the Big Three were guaranteed business from issuers and competition between them became not one of quality but of quantity.[24] It was a race to the bottom – not to the top.

B. *Ownership, Remuneration, and Priorities*

Many of the problems with CRAs arise from the way they are governed. This, in turn, is influenced by the way CRAs are owned, since directors' duties are primarily to the shareholders of their company. The Big Three are privately and wholly owned by some of the world's largest publishing and business analytics companies.[25] In 2009 alone, the Big Three were responsible for 98% of all credit ratings worldwide.[26] In 2012, they accounted for 94% of rated structured products globally, and 97% of all ratings recognised by the SEC.[27]

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[22] See, eg, Jan Oster, '"Who Rates the Raters?" The Regulation of Credit Rating Agencies in the EU' (2010) 17 *Maastricht Journal of European and Comparative Law* 353, 356.
[23] Mullard, above n 2, 79.
[24] See, eg, Thomas J Fitzpatrick IV and Chris Sagers, 'Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations' (Research Paper 09-171, *Cleveland-Marshall College of Law*, 2009), 25.
[25] Moody's Investor Service is a wholly-owned subsidiary of Moody's Corporation, which is owned by Dun & Bradstreet, an American business analytics company. Standard & Poor's is owned by McGraw-Hill, which is a publishing and media company, and Fitch Ratings, a wholly-owned subsidiary of Fitch is owned by FIMALAC, a French financial conglomerate: see Miglionico, above n 5, 67. See also Steven L Schwarcz, 'The Universal Language of Cross-Border Finance' (1998) 8 *Duke Journal of Comparative and International Law* 235, 251-252; Schwarcz, above n 20.
[26] Django Gold, 'Berating the Raters' (2009) 35(3) *NACD Directorship* 12.
[27] Diego Cisneros, Edmundo R Lizarzaburu and Julio Quispe Salguero, 'Credit Information in Emerging Markets: The Rating Agencies and Credit Risk Reports,

The fact that CRAs are private companies means two things. First, it means that the corporate purpose is to benefit its owners, who are, according to an academic, corporations 'not disinterested in the financial markets'.[28] The Financial Crisis Inquiry revealed that the corporate purpose of CRAs was to generate revenue.[29] CRAs 'placed market share and profit considerations above the quality and integrity of their ratings'.[30] On admission by a Big Three executive, 'profits were running the show',[31] and CRAs competed with one another to retain a steady stream of business from issuers.[32] Government hearings and testimonies from key Big Three executives confirm the moral hazard – CRAs deviated from ratings methods, models, and policies, substantially without properly documenting the reason, justification and authority for doing so.[33] Managers encouraged these discretions in order to make clients happy, capitalise on remuneration policies,[34] and increase overall market share, and the lack of internal procedures allowed this conduct to continue without consequence.[35]

The private holding of CRAs is largely to blame, since it meant that the problem of weak governance and skewed pay policies escaped regulatory intervention and investor attention until damage had already been done. As an earnings management study shows, remuneration policies which reward employee performance with shares or options tends to promote deceptive or strategic behaviour on the part of the employee to maximise the dollar value of their compensation package.[36] Whilst this behaviour was typical in investment banks, it also manifested in CRAs. Managers demanded higher outputs of high credit

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Peruvian Experience' (2012) 7(24) *International Journal of Business and Management* 35, 36.

[28] Miglionico, above n 5.

[29] Gretchen Morgenson, 'House Panel Scrutinizes Rating Firms', *New York Times* (New York), 23 October 2008, B1. This article is also available online: <http://goo.gl/wcGQEu>.

[30] Financial Crisis Inquiry, above n 10, 212.

[31] Frank L Raiter, head of mortgage ratings at Standard and Poor's in Morgenson, above n 29.

[32] Ibid.

[33] Staff of the Office of Compliance, Inspections and Examinations, Division of Trading Markets and Office of Economic Analysis, 'Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies' (SEC, 8 July 2008), 103 <http://goo.gl/kxCpNi> ('*SEC Summary Report*'),14. See also Tin A Bunjevac, 'Credit Rating Agencies: A Regulatory Challenge for Australia' (2009) 33 *Melbourne University Law Review* 39; Andrew Johnston, 'Corporate Governance is the Problem, Not the Solution: A Critical Appraisal of the European Regulation of Credit Rating Agencies' (2011) 2(2) *Journal of Comparative Law Studies* 395.

[34] Johnston, above n 33.

[35] Mark Froeba, Testimony before the Financial Crisis Inquiry Commission, (2 June 2010), 4-15 <http://goo.gl/fr0hCF>.

[36] Gary L Caton et al, 'Earnings Management Surrounding Seasoned Bond Offerings: Do Managers Mislead Rating Agencies and the Bond Market?' (2011) 46(3) *Journal of Financial and Quantitative Analysis* 687, 705.

ratings,[37] and the Financial Crisis Inquiry confirms that managing directors of CRAs received stock options whilst executive performance was based on 'market coverage, revenue, and market outreach'.[38] During Brian Clarkson's tenure as managing director, Moody's market share in rating residential mortgage-backed securities quadrupled.[39] As a senior executive recounts, it was only because Moody's, under Clarkson's direction, had a policy of making 'major methodological changes not otherwise warranted by the availability of new data or some other substantive trigger',[40] and defiance in favour of upholding analytical merit meant immediate unemployment.[41]

This focus on profit compromised the integrity of the ratings process. Managing directors threatened key analysts and other managers with unemployment if ratings criteria or models were not favourably adjusted in order to produce a desirable rating.[42] Analysts were reminded to strive for greater market share rather than greater accuracy,[43] and were asked to 'adjust' ratings criteria whilst management made them aware of fees, competition, and the rating methods employed by competing CRAs.[44] The paramount consideration then was (and arguably, still is) to increase the CRA's market share,[45] since CRAs depended on a profitable flow of business from loyal clients in order to generate revenue, and to bolster and build reputation.[46]

C. *Reputation, Self-Regulation, and Accountability*

Reputation has a special function in the context of CRAs. It was argued that the risk of reputational damage arising from an inaccurate rating meant that CRAs could be trusted to self-regulate.[47] The justification for not regulating the ratings process was that CRAs run the risk of losing credibility if credit ratings were inaccurate, since a CRA that has no credibility amongst investors is less likely to

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[37] Froeba, above n 35.
[38] Financial Crisis Inquiry, above n 10.
[39] Froeba, above n 35.
[40] Ibid.
[41] Ibid. See also Mullard, above n 2, 77, 85, 89; Johnston, above n 33, 15.
[42] Froeba, above n 35. See also Mullard, above n 2, 77, 85, 89.
[43] Mullard, above n 2, 89-90.
[44] SEC, Summary of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies (2008) ('*SEC Summary of CRA Issues*'), 24-26.
[45] Ibid. Frank Strier, 'Rating the Raters: Conflicts of Interest in the Credit Rating Firms' (2008) 113(4) *Business and Society Review* 533,537-538; Frank Strier, 'Conflicts of Interest in Corporate Governance' (2005) 19 *Journal of Corporate Citizenship* 79.
[46] IOSCO Technical Committee, 'The Role of Credit Rating Agencies in Structured Finance Markets' (March 2008), 15 ('*IOSCO Report*') <http://goo.gl/ygSpUe>.
[47] Deryn Darcy, 'Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It' (2009) 2 *Columbia Business Law Review* 605, 658.

attract business from issuers than its more credible peers. However, the pro-cyclical nature of reputation discounted this theory. Reputation is a pro-cyclical factor in the CRA setting for two reasons. The first is that CRAs depend on their reputation of being widely used and trusted by investors in order to attract business from issuers. The second is that CRAs needed a consistent flow of business from issuers in order to develop and maintain that reputation. Losing a single client meant losing a large share of that market.[48] The Big Three were largely successful in obtaining business from issuers, often to the extent of overworking analysts.[49]

Ideally, the credibility of a CRA ought to hinge on the quality of its analyses and the accuracy of its ratings. However, that is not the case. One study has shown that loyalty to a particular CRA results in better credit rating outcomes even though the underlying risks and credit quality did not improve.[50] Credit ratings do not have to be accurate for investors to rely on them, since credit ratings are already deeply embedded in commercial contracts and financial regulation to the extent that reference, if not reliance, is inevitable.[51] A study commissioned by the International Monetary Fund has found that credit ratings can cause and exacerbate herding behaviour amongst investors,[52] in spite of past inaccuracies.

Firstly, the lack of transparency inhibits the ability of investors and regulators to judge the past performance of CRAs – recall that CRAs are privately-owned entities, meaning CRAs are not obliged to disclose this kind of information to the public. Even today, investors cannot properly judge the credibility of particular CRAs and the credit ratings they issue because of the lack of information about CRA past performance. CRAs are not under any obligation to publish this kind of information.[53] Similarly, information on rating methods and policies are not available, and rating models are, according to CRAs, proprietary.[54] It would be difficult for CRAs to profit, they argue, if their proprietary models were available to

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48 Mark Carl Rom, 'The Credit Rating Agencies and the Subprime Mess: Greedy, Ignorant, and Stressed?' (2009) 69(4) *Public Administration Review* 640, 645.

49 Amadou N R Sy, 'The Systemic Regulation of Credit Rating Agencies and Rated Markets' (2009) 10(4) *World Economics* 69, 92.

50 Thomas Mahlmann, 'Is There a Relationship Benefit in Credit Ratings?' (2011) 15 *Review of Finance* 475.

51 See, eg, Hatchett, above n 11; Basel II, above n 13; Nicholls, above n 17; Braithwaite, above n 18.

52 Charles Adams, Donald J Mathieson and Garry Schinasi, *International Capital Markets: Developments, Prospects, and Key Policy Issues* (September 1999) International Monetary Fund <http://www.imf.org/external/pubs/ft/icm/1999/>. See also Sy, above n 49.

53 Darcy, above n 47, 628.

54 Frank Partnoy, 'Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective' (Research Paper No 09-014, *Legal Studies Research Paper Series University of San Diego*, July 2009), 11.

the public, since this eliminated the need for CRAs to conduct the rating. However, this argument is flawed, given that it is only CRAs that have access to confidential information which form part of the qualitative assessments involved in the ratings process – only CRAs are exempt from disclosing this information under insider trading laws.[55] Everyone else is required, by law, to disclose this kind of information and hence, issuers are unwilling to provide this information to anyone but CRAs. Even if rating models and methods were made public, CRAs are able to retain this informational advantage. The reason behind CRA reluctance to disclose models is mainly because of profitability and competition – publication of proprietary models would allow rivals to adjust their own models to attract and please clients, as has been the case. Analysts at one particular Big Three had been informed of rivals' models and were directed to adapt house criteria to suit client needs,[56] so the competition is very real.

Second, it meant that CRA directors and officers were not held accountable for bad governance, despite the public significance of credit ratings from a regulatory and investor perspective. The issuer-pays model, where the issuer pays the CRA directly for the rating, posed a conflict of interest. Issuers could influence the outcome of the ratings process. After all, CRAs needed issuer business to survive, and a CRA that was unwilling to compromise its standards would lose out on revenue and reputation to their rivals. CRAs have lost their share of a particular market segment due to downgrades, unfavourable ratings, or reluctance to adjust mathematical models or ratings criteria. A Big Three lost more than 50% of its market share after issuing a series of downgrades.[57] Given that 80% of mortgage-backed securities were underwritten by just twelve issuers, losing a client meant losing a large share of that particular market.[58] In fact, these major issuers comprise the bulk of the reputational capital of the Big Three.[59] Similar commercial considerations meant that CRAs were reluctant to ask searching questions during the ratings process, or to review credit ratings downwards for fear of losing future business from issuer-clients. CRAs manifested the same reluctance when it came to pressing clients for documents. As an internal e-mail (revealed during the course of a government enquiry)

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[55] SEC Selective Disclosure and Insider Trading Rules, Part 243 ss 243.100(2)(iii) <http://www.sec.gov/rules/final/33-7881.htm> ('*SEC Disclosure Rules*').
[56] SEC Summary of CRA Issues, above n 44.
[57] Aaron Lucchetti, 'Ratings Firms' Practices Get Rated', *Wall Street Journal* (New York), 7 September 2007, C1 at C2 referred to in John C Coffee Jr, Testimony before the Senate Banking Committee, 'The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets' (6 September 2007), 6 <http://goo.gl/E9dgkR>.
[58] Rom, above n 48.
[59] IOSCO Report, above n 46, 15.

shows, issuers had the habit of providing supporting documents the night before a decision was due.[60]

D. *Profits from Conflicts*

Compounding the problem further, CRAs were unlikely to receive fees up-front. Although CRAs were contractually entitled to receive fees upon conclusion of the ratings process, it was common practice for issuers to pay after profits had been received from the sale of the rated product.[61] This meant that the integrity of the ratings process was even more susceptible to issuer influence – issuers were only willing to pay for credit ratings if the rating was favourable and reduced their cost of capital.[62] CRAs did not press for payment for fear of alienating clients, and rating agencies which refused to lower rating criteria or adjust rating models risk losing out to their less honest peers.[63] Issuers were free to 'ratings-shop' without pecuniary consequences since they withheld fees, and conduct of this kind did not attract regulatory censure. At least one of the Big Three had a policy of charging higher fees in return higher credit ratings,[64] further incentivising CRAs to issue desirable, instead of accurate, credit ratings. CRAs had nothing to lose and all to gain, as they enjoyed 'journalistic immunity' since credit ratings were classified as expressions of opinion.[65] CRAs remain immune from civil action for unreliable credit ratings, causing the lack of internal rating quality control. In one instance, Standard and Poor's made a $2 trillion error in its calculations, maintained its rating after discovering that error, and suffered no consequence.[66] Whilst a decision from the Federal Court of Australia has countenanced and

[60] Email from Eric Kolchinsky to Yvonne Fu and Yuri Yoshizawa, 30 May 2006. A copy of this e-mail is available online at <http://goo.gl/usd6sd>.
[61] This was the answer of the former managing director of Moody's who oversaw the rating of financial products with underlying sub-prime mortgages in response to the Commission's inquiries – see SEC Summary Report, above n 33, 103 <http://goo.gl/kxCpNi>. See also Patrick Bolton, Xavier Freixas and Joel Shapiro, 'The Credit Ratings Game' (2012) 67(1) *The Journal of Finance* 85.
[62] Stephane Rousseau, 'Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach' (2006) 41 *McGill Law Journal* 617, 637.
[63] Lynn Bai, 'On Regulating Conflicts of Interest in the Credit Rating Industry' (2010) 13 *Journal of Legislation and Public Policy* 2, 263.
[64] This was acknowledged by the then-CEO of Moody's, Mr. Raymond McDaniel in response to a question by Commissioner Byron S Georgiou. See Official Transcript, *Testimony at the Hearing on Credibility of Credit Ratings, the Investment Decisions Made Based on Those Ratings, and the Financial Crisis* (Hearings and Testimony, Financial Crisis Inquiry Commission, 2 June 2010), 274-276 <http://goo.gl/NCpIYh>.
[65] See, eg, *Jefferson County School District v Moody's Investor's Services,* 988 F Supp 1341 (D Colo 1997), 14 ('*Jefferson v Moody's*'). See also Darcy, above n 47, 632; Gregory Husisian, 'What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability' (1990) 75 *Cornell Law Review* 411.
[66] Tony Malkovic, 'Falling Credit Ratings Ahead', *The Big Picture* (March 2012), 16.

sanctioned this kind of negligent behaviour, the decision has been appealed and the resolution of this case remains pending.[67] The unsatisfactory situation remains that CRAs are still able to retain the profits of their own negligent conduct.

Another example of a morally hazardous conflict of interest is the practice of offering ancillary ratings services like pre-ratings assessments and ratings consultancy. In the former, CRAs provide issuers with a tentative rating in exchange for a fee, allowing issuers to 'test-run' the structure of a product and whether it can achieve an investment-grade rating. In the latter, issuers would consult a CRA for advice on how to structure products in order to achieve a desired rating. Whilst the practice of providing ratings consultancy and advisory services to issuer-clients is now restricted by Dodd-Frank,[68] issuers are still free to engage on the one hand, a first CRA to provide consultancy services and on the other, a second CRA to formally rate the product. Even though CRA methods are not transparent and the models employed are mostly proprietary, anecdotal evidence shows that informational leakages occur, given that in one instance, CRA management made analysts aware of the mathematical models used by their competitors.[69] The availability of these ancillary services jeopardise integrity of credit ratings in general, since it enabled issuers to manipulate the ratings process by adjusting the structure of their products to obscure risks and conceal exposures in ways which CRA models and policies could not detect.

E. *Summary of Governance Failures*

Other instances of bad governance went unchecked. The following is a summary of what went wrong:

1. Poor record-keeping:
    a. minutes of committee meetings were so brief that a quarter of such meetings failed to record the name of the chairperson;[70]
    b. out-of-model adjustments were poorly, if ever, documented.[71]
2. Lack of quality control:
    a. no internal procedure to test and update ratings models, methods, policies and results;[72]

[67] *Bathurst Case* [2012] FCA 1200.
[68] See Title IX, Subtitle C, ss931-939H of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L No 111-203. § 939, 124 Stat 1376 (2010) ('*Dodd-Frank Act*'). See also McNamara, above n 3, 722.
[69] SEC Summary of CRA Issues, above n 44.
[70] SEC Summary of CRA Issues, above n 44,19-20.
[71] SEC Summary Report, above n 33, 14.

   b. post-rating accuracy monitors and revision was poor and under-funded despite large margins and record profits;[73]
   c. management-endorsed culture of reluctance to downgrade ratings for fear of alienating client base.[74]
3. Understaffed and overworked: CRAs did not employ additional analysts despite increased workloads. Management pressured analysts to prioritise compliance with timelines than sound analytics.[75]
4. No due diligence: CRAs did not have a practice of verifying underlying facts and assumptions for fear of offending clients.[76] Instead, adjustments were made in order to produce desirable ratings, satisfy clients, and maintain a profitable flow of business.[77]
5. Conflict Management: CRAs offered consulting services and pre-rated products in exchange for a fee. These businesses were mainly ancillary. However, by offering these services, CRAs made the objectivity of the primary business of CRAs questionable.
6. Inappropriate remuneration schemes:
   a. CRA managers and directors were rewarded for retaining and widening client base and market share instead of rating quality;[78]
   b. Analyst compensation was insufficient, causing analysts to 'jump ship' and work for investment banks, including those which they rated before.[79]

Practices of this kind continued without consequence, as long as a profit was turned. Analysts, managers and CRAs were not made responsible, liable or disciplinable, by shareholders or by law. After all, the Big Three were wholly

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[72] The primary complaint against CRAs is that CRAs continued to use mathematical models framed for classic, 30-year mortgages to rate sub-prime mortgage-backed products which were non-traditional, had variable rates and terms, poorer credit quality, and higher credit risk. See, eg, Strier, above n 45, 534-535; Mullard, above n 2, 77; Bunjevac, above n 33; de Meijer, above n 13, 324.
[73] Official Transcript, *Testimony at the Hearing on Credibility of Credit Ratings, the Investment Decisions Made Based on Those Ratings, and the Financial Crisis* (Hearings and Testimony, Financial Crisis Inquiry Commission, 2 June 2010, 39-40, 44-98. See generally Partnoy, above n 54.
[74] Froeba, above n 35.
[75] Ibid.
[76] Ibid. See also, eg, Timothy E Lynch, 'Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment' (2009) 59(2) Case Western Reserve Law Review 227, 255-256; John C Coffee, 'Enhancing Investor Protection and The Regulation of Securities Markets' (Working Paper No 348, Columbia Law and Economics, 10 March 2009).
[77] Froeba, above n 35. See also Financial Crisis Inquiry, above n 10.
[78] See, eg, Financial Crisis Inquiry, above n 10, 212.
[79] Heski Bar-Isaac and Joel Shapiro 'Credit Rating Accuracy and Analyst Incentives' (2011) 101(3) *American Economic Review: Papers & Proceedings* 120.

owned by a single shareholder, and this kind of behaviour was implicitly ratified, if not expressly endorsed, by the lack of shareholder complaint and action.

III. Regulatory Responses: Reactions and Reflections

This section provides an analysis of the regulatory responses to the CRA governance failures revealed during the global financial crisis and the way CRAs have reacted to these new regulations. In summary:

1. Principles-based 'soft law' approaches have failed because CRAs are able to exploit its flexibility due to the lack of an organic, market-based enforcement mechanism.
2. Legislative 'hard law' responses attempt to decrease regulatory and investor reliance on credit ratings. However, their efficacy remains to be seen.
3. Credit ratings continue to attract immunity from civil liability under the common law, given judicial interpretation that credit ratings are opinions which are protected by the freedom of speech provisions in the First Amendment.

A. *Soft Law: Flexibility and Failure*

Akin to the ASX Corporate Governance Principles and Recommendations,[80] CRAs are required to adopt and implement the Code of Conduct prescribed by the International Organization of Securities Commissioners ('IOSCO').[81] The Code prescribes a number of high-level objectives aimed at addressing CRA conflicts and governance failures. Whilst the Code was developed in response to the failures of CRAs of the global financial crisis the code itself was derived from a statement of principles published several years before.[82] Unlike the ASX Principles, however, compliance with the IOSCO Code and Principles has been unsatisfactory[83] for a number of reasons. Despite the fact that IOSCO had already identified various issues with CRA governance in 2003, the following paragraph demonstrates that CRAs largely ignored the Principles.

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[80] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations with 2010 Amendments* (2nd ed) <http://goo.gl/eJTmA9> ('ASX Principles'). See also Organisation for Economic Co-operation and Development, *OECD Principles of Corporate Governance* (2004) < http://goo.gl/e3jfe3>.
[81] International Organization of Securities Commissioners, *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies* (Revised May 2008) ('*Code*').
[82] IOSCO Statement of Principles Regarding the Activities of CRAs (25 September 2003) ('*Principles*').
[83] See de Meijer, above n 13, 331.

To protect the integrity of credit ratings and to ensure that credit ratings are accurate, CRAs should continually monitor and update credit ratings.[84] However, we know that CRAs failed to adhere to this principle in two ways. Firstly, note that CRAs are reluctant to issue downgrades for fear of alienating issuers and losing a large share of the market.[85] For instance, CRAs failed to downgrade Enron on the basis of credible public information, and only did so when bankruptcy was four days away.[86] Secondly, note that CRAs failed to update rating models and methods in the lead-up to the global financial crisis –sub-prime mortgage-backed securities were rated as if they were traditional 30-year mortgages.[87] CRAs were asked to maintain documentary records justifying their ratings.[88] However, we know that record-keeping in CRAs was poor, even after the Principles were published.[89] As for conflicts of interest, IOSCO recognised that CRA ownership had the potential to influence the outcome of the ratings process and asked CRAs to implement procedures aimed at ensuring that the ratings process was as objective as possible.[90] However, we know that CRAs prioritised profits over ratings accuracy and integrity.[91] The issuer-pays model was also a major area of concern. CRAs were asked to ensure that the ratings process was not influenced by fee arrangements or their relationship with issuers.[92] However, we know that 'the ratings process became a negotiation'[93] and CRAs were very much influenced by fees.[94] Presciently, the Principles asked CRAs to from engaging in activities, relationships, or procedures that may compromise or appear to compromise CRA independence and ratings integrity.[95] However, we know that CRAs continued to provide ancillary services to issuers which brought the objectivity of the ratings process into question.[96] Concerning remuneration,

[84] Ibid, Principle 1.2. See also Code 1.7-2 in IOSCO Code, above n 81, 1.7-2, 1.9.
[85] Lucchetti, above n 57.
[86] Miglionico, above n 5, 34.
[87] Mullard, above n 2,77.
[88] IOSCO Principles, above n 82, Principle 1.3. See also Code 1.5 in IOSCO Code, above n 81.
[89] SEC Summary of CRA Issues, above n 44, 19-20.
[90] IOSCO Principles, above n 82, Principle 2. See also Code 2.4 in IOSCO Code, above n 81.
[91] Financial Crisis Inquiry, above n 10, 212; Froeba, above n 35.
[92] IOSCO Principles, above n 82, Principle 2.2. See also Codes 2.4, 2.12 in IOSCO Code, above n 81.
[93] Aaron Lucchetti, 'Rating Game: As Housing Boomed, Moody's Opened Up' (*Wall Street Journal*), New York, 11 April 2008.
[94] Froeba, above n 35.
[95] IOSCO Principles, above n 82, Principle 2. See also Code 2.4, 2.12 in IOSCO Code, above n 81.
[96] Carol Ann Frost, 'Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies' (2007) 22(3) *Journal of Accounting, Auditing & Finance* 469, 480. See also SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market' (January 2003), 43.

IOSCO reminded CRAs that compensation packages should promote independence and minimize conflicts of interest.[97] However, we know that directors and managers were compensated based on revenue and market share,[98] and in the result, analysts were put under intense pressure to deliver favourable ratings so that directors and managers could maximise the dollar value of their compensation packages.[99] IOSCO advocated for increased transparency so that investors could make better-informed judgements on credit rating accuracy. CRAs were asked to publish, voluntarily, information about their policies, methods, and past performance.[100] However, we know that CRAs hardly published any useful. Further, since CRAs frequently deviated from their own models, methods and policies without documentary justification, this information was largely irrelevant and did not reflect the ratings process for the majority of credit ratings.[101]

The inefficiency of the IOSCO Code and Principles can be explained by several reasons. Firstly, there is a lack of incentive to comply and there are no disincentives to non-compliance. Whilst the IOSCO Code mirrors ASX Principles by requiring CRAs to 'adhere or explain' instances of non-compliance, CRAs are, unlike ASX-listed companies, privately-owned enterprises. The Big Three CRAs are wholly-owned entities. This means that a market enforcement mechanism does not exist to reward CRA compliance or to censure non-compliance, whereas in the context of the ASX Principles, such disclosure has empowered investors to express their discontentment with a company's governance by selling their shares in the company where compliance with the ASX Principles has not been proper or explanation for non-compliance is inadequate. Arguably, the risk that share price will be negatively affected by poor compliance has contributed to the success of the ASX principles and has led to higher levels of voluntary corporate disclosures in general.[102] However, such a risk is not

[97] IOSCO Principles, above n 82, Principle 2.4. See also Code 2.12 in IOSCO Code, above n 81.

[98] Financial Crisis Inquiry, above n 10. See also C Smith and Ingo Walter, 'Rating Agencies: Is There an Agency Issue?' (*Stern School of Business, New York University*, Feb 2001), 44.

[99] See, eg, Froeba, above n 35; Johnston, above n 33, 410; Caton, above n 36, 705.

[100] IOSCO Principles, above n XX, Principle 3.3.

[101] See, SEC Summary of CRA Issues, above n 44, 14; Bunjevac, above n 33, 14; Johnston, above n 33, 410.

[102] See Financial Reporting Council (UK), *Response to the European Commission Green Paper on the EU Corporate Governance Framework* (No 8830/11 COM(11) 64, July 2011), 31-37; OECD Steering Group, on Corporate Governance, *Corporate Governance and the Financial Crisis – Conclusions and Emerging Good Practices to Enhance Implementation of the Principles* (24 February 2010), 3-4; Recommendations of Walker Report, *A Review of the Corporate Governance in UK Banks and other Financial Industry Entities* (26 November 2009).

substantial enough to coerce CRAs into compliance, given that CRAs are privately owned. CRAs used to be the primary source of profit for CRA owners but no longer are,[103] so relationship between CRA governance and CRA-owner share price is now too remote to trigger shareholder disapproval.

Secondly, CRAs are only obliged to report their compliance with the IOSCO Code to regulators.[104] This leaves investors with little to no information on the quality and integrity of CRA governance and procedures. As a consequence, investors are not able to critically question and scrutinise the ratings issued by CRAs. Regulators also lack the power to officially sanction CRAs for unsatisfactory compliance with the spirit of the IOSCO Code, meaning that CRAs only complied minimally with the disclosures required by the SEC.[105] CRAs have been able to exploit the flexibility of the IOSCO Code without immediate consequences, whereas in the ASX setting, this kind of behaviour would be the subject of public disclosure, investor scrutiny, and shareholder disapproval. Given the lack of enforcement, this practice continues and remains unchecked.

B. *Hard Law: Not Good Enough*

The Credit Rating Agency Reform Act of 2006 ('CRARA') introduced a new obligation on the part of CRAs.[106] CRAs were required to identify and propose a course of action to manage the conflicts of interest which arise in the CRA setting.[107] Although this was an improvement in comparison to a complete lack requirement to disclosure, the regulations only require disclosure to the SEC only and not public. Similar to the Dodd-Frank improvement discussed below, investors and financial analysts suffer from an information black-out: they do not know how CRAs manage the conflicts and as a result, can neither properly assess the integrity of the ratings process nor judge whether a credit rating was issued objectively. Save for the most sophisticated ones, investors continued to perceive credit ratings as regulatory licences. CRARA also specifically prohibits the regulation of the mathematical models, internal procedures, ratings policies and analyses methodologies used by CRAs.[108] This prohibition carries part of the blame for the bulk of inaccurate credit ratings which caused the sub-prime mortgage crisis. Since CRA methods and policies were not regulated, internal

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[103] Jody Shenn and Sarah Mulholland, 'McGraw-Hill Hires Groves for New S&P Ombudsman Post' (*Bloomberg*), 7 January 2009 <http://goo.gl/0Hhym5>.

[104] In Australia, reports are collected by the Australian Securities and Investments Commission ('*ASIC*'). See also ASIC, 'Credit Rating Agencies: IOSCO Code Annual Compliance Report' (Consultation Paper No 160, 1 June 2011) <http://goo.gl/OZcybD>.

[105] SEC Summary of CRA Issues, above n 44, 13-14; Darcy, above n 47, 628.

[106] SEC Summary of CRA Issues, above n 44, 646; Rom, above n 48.

[107] Ibid.

[108] Rom, above n 48, 643.

supervision and quality control was lax. Analysts made the wrong assumptions and used outdated mathematical models without regulatory repercussions or internal disciplinary consequences.[109]

In response to these issues, the Dodd-Frank Act attempts to decrease regulatory reliance on credit ratings by removing references to credit ratings from six major pieces of federal law and requiring all federal agencies to develop internal standards and assessments of creditworthiness to replace credit ratings.[110] However, given that subjective datasets also form part of the ratings process, it is difficult to see how Dodd-Frank can permanently regulatory reliance. CRAs often request (although a key complaint is that they do not verify)[111] and analyse commercially-sensitive information from issuers, such as latest financial statements, internal risk reports and forecasts, and cash flow projections, as a part of the process.[112] CRAs have access to this information because they are absolved from disclosure under the SEC Rules,[113] an advantage that in-house and external credit analysts do not enjoy. Although CRAs lack the power to compel issuers to provide or prove the truth of information, the incentives for CRAs to nurture an amicable commercial relationship with issuers outweigh any sense of duty and responsibility to protect the integrity of the ratings process, given that CRAs have no public duty (since they are privately owned) and have no liability for inaccurate ratings.[114] Investors, financial analysts, and even regulators remain at an informational disadvantage when it comes to assessing the credit rating and credit risk of structured products.

Whilst the Dodd-Frank did attempt to address what went wrong with regard to CRAs, it stopped short of requiring CRAs to conduct due diligence on the facts and assumptions on which credit ratings are based.[115] It did not establish incentives to encourage CRAs to do so, and did not create disincentives for omissions. A common complaint of analysts is that they lacked the power to compel issuers to provide information and documents or to prove that whatever

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[109] See, eg, Strier, above n 45, 534-535; Mullard, above n 2, 77; Bunjevac, above n 33; de Meijer, above n 13, 324.
[110] *Dodd-Frank*, s 939. See generally Senate Banking Commission, *Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act,* (1 July 2010) <http://goo.gl/TjiDe0>. See also McNamara, above n 3.
[111] Miglionico, above n 5, 34.
[112] IOSCO Board, 'Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of Credit Ratings Process and Procedures to Manage Conflicts of Interest' (No FR12/12, December 2012), ('*IOSCO Internal Controls*') 10.
[113] SEC Disclosure Rules, above n 55.
[114] Darcy, above n 47, 632.
[115] Lynn L Dallas, 'Short-termism, the Financial Crisis, and Corporate Governance' (2011) 37 *Journal of Corporation Law* 264, 331.

information they gave was true.[116] Fee structure meant that the balance of power within the CRA-issuer relationship tilted in favour of the issuers. Consequently, internal procedures did not require analysts or managers to conduct due diligence on factual assumptions.[117] The Securities Act immunises CRAs from civil litigation.[118] Section 11 expressly prohibits civil action against CRAs,[119] removing a disincentive for inaccurate or negligently-issued ratings. Is this good law? In light of the special position and immunity enjoyed by CRAs, should it not at least behove the CRA to verify the information and assumptions underlying each credit rating, given the importance of credit ratings?

C. *Civil Liability: A Matter of Opinion?*

Whilst several commentators suggest that civil liability can have a positive effect on CRA performance and credit rating accuracy,[120] judicial opinion continues to afford credit ratings with protection under freedom of speech laws (in other words, journalistic immunity).[121] However, the reason for this is primarily related to legacy rather than logic. A historical account of the development of CRA journalistic immunity is that CRAs once operated under a subscriber-pays model. CRAs would publish ratings to fee-paying subscribers. Given that firstly, the number of subscribers was substantial and secondly, indeterminacy arose because of the problem of free-riders, courts had to limit CRA exposure to civil liability as a matter of fairness. Free-riders are parties who privately contracted with fee-paying subscribers to share the benefits of subscription with one another. The act of free-riding was mutual, since a free-rider would subscribe with a certain CRA and the counterparty would subscribe with another. This problem was inherent in the model itself, causing the Big Three to eschew subscriber-pays in favour of issuer-pays. Despite the change in fee structure and the scaled nature of CRA fees today,[122] CRAs continue to enjoy journalistic immunity. Considering the conflicts discussed above, it is unlikely for issuers to want to pursue CRAs for issuing overly-favourable ratings. It is hard for investors to

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[116] See generally Mullard, above n 2.
[117] Ibid, 80, 83. See also A Cifuentes, Testimony of Arturo Cifuentes before the US Senate Permanent Subcommittee on Investigations (Washington DC, 23 April 2010), 7.
[118] *Securities Act of 1933* Pub L No 112-106, § 11 (2012). A copy of the act is available online at<http://www.sec.gov/about/laws/sa33.pdf>.
[119] See Partnoy, above n 54, 14. See also Darcy, above n 47, 631.
[120] See, eg, Husisian, above n 65, 430; Partnoy, above n 54, 14.
[121] See, eg, *Jefferson v Moody's* 988 F Supp 1341 (D Colo 1997), 14.
[122] Fees are calculated on a percentage basis of – Moody's charged 4.75 basis points per dollar when a credit rating was above a certain grade, and 3.75 basis points per dollar for lower outcomes. See Official Transcript, *Testimony at the Hearing on Credibility of Credit Ratings, the Investment Decisions Made Based on Those Ratings, and the Financial Crisis* (Hearings and Testimony, Financial Crisis Inquiry Commission, 2 June 2010), 274-276 <http://goo.gl/NCpIYh>.

establish that they have the requisite standing to sue, due to the restrictions under the Securities Act and also because the question of indeterminate liability still arises. Investors have been successful in cases where credit ratings were published for select purposes to a specific audience, rather than publicly announced.[123] If a CRA is found negligently liable for inaccurate ratings, what stops it from being liable to the whole market?

The European Parliament recently expressed an intention to expose CRAs to liability for inaccurate ratings where regulatory obligations depend on credit ratings.[124] The reasons for this are several, and are equally applicable to the Big Three and regulation in the USA. Firstly, credit ratings and CRAs are 'largely commercial in nature',[125] and lack the independence that warrants journalistic immunity.[126] Further, ratings are, unlike news, largely solicited[127] and rendered for profit, often handsomely.[128] CRAs typically enjoy a 50% profit margin. In comparison, the profit margin of a publisher-newsgatherer is 10%.[129] CRA compensation schemes mirror financial services firms as a result,[130] so there is room for argument that liability should be imposed on CRAs because it would be the most risk- and cost-efficient way of deterring undesirable behaviour. CRA profit margins are so large that a lack of civil liability would encourage negligent behaviour, something that is morally hazardous to investors. In order to counteract the factors which encourage CRAs to issue inaccurate ratings (namely, the profit mandate of most CRAs and the bargaining power of issuers), CRAs need to be at risk of liability when credit ratings are inaccurate. Whilst civil liability could be very costly because credit ratings are widely published, this cost is, comparatively speaking, a proportionate one if balanced against the profit margins that CRAs enjoy and the demand for credit ratings which is practically guaranteed. Credit ratings are already deeply embedded in many national and international regulatory obligations and commercial contracts – so much so that disposing of credit rating reference points altogether would disrupt the global financial markets. Risk of civil liability forces CRA directors and managers to

[123] See, eg, *Dun & Bradstreet Inc v Greenmoss Builders Inc* (1985) 472 U.S. 749 cited in Rachel Jones, 'The Need for a Negligence Standard of Care for Credit Rating Agencies'(2010) 1(1) *William & Mary Business Law Review* 201, 215.
[124] Panagiotis K Staikoras, 'A Theoretical and Empirical Review of the EU Regulation of Credit Rating Agencies: In Search of Truth, Not Scapegoats' (2012) 21(2) *Financial Markets, Institutions & Instruments* 71, 130.
[125] *Dodd–Frank Act*, s 931.
[126] Staikoras, above n 124, 133.
[127] Ibid, 132.
[128] Above n 119.
[129] Partnoy, above n 54, 15-16.
[130] Ibid.

improve internal controls in order to manage these conflicts and improve the accuracy of credit ratings in general.[131]

D. *Summary of the Regulatory Landscape*

Whilst the issues which arise as a result of credit ratings and the way CRAs are governed have been identified, principles-based governance has failed to remedy poor governance practices and legislative innovations have yet to bear results.

IV. Moving Forward

Since the problems with the way CRAs are internally and externally governed have been identified, this section examines the feasibility of a handful of proposed solutions. Firstly this part will provide an outline of the initiatives taken by the Big Three before discussing whether these initiatives can adequately address the conflicts and problems with CRAs. Secondly, the structure of CRA remuneration schemes will be examined.

1. What initiatives have the Big Three taken, and do these initiatives adequately address the problems?
2. How should CRA compensation schemes work?
3. Should analysts have professional training and liability?
4. Can increased mandatory disclosure remedy CRA governance failures?
5. Is a multi-rating requirement feasible?
6. Should there be a Chief Analyst, sitting at board level?
7. Forcing CRAs to go public – will this increase CRA accountability?
8. What are the relevant policy considerations?

A. *Big Three Initiatives*

Whilst the Big Three have introduced some of their own initiatives into the fray, the key weakness in their approach remains the lack of public disclosure. The Big Three endeavoured to erect Chinese Walls between their analysts and business-minded employees. Whilst Dodd-Frank prohibited analysts from participating in fee negotiations,[132] the Big Three sought to go one step further by separating their ratings division from their ancillary consulting and pre-ratings assessment businesses. However, it is difficult to appreciate that this separation can work as a proper Chinese Wall if both divisions are either still governed by the same board of directors and senior managers or owned by the same parent company. At least the latter remains the case today.

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[131] See generally Partnoy, above n 54.
[132] *Dodd–Frank Act*, s 932.

Another example exists. For instance, although Standard and Poor's established an in-house ombudsman to address internal and external concerns about their integrity,[133] the findings of the office are only made to internal governors and are not publicly available. The ombudsman does not increase the visibility of CRA practices and procedures, so it is still possible for morally hazardous behaviour to go undetected or receive the ratification from shareholders. This paper suggests one of two things in relation to the ombudsman's office: make these reports publicly available, or create an independent ombudsman's office which oversees whilst being external to and funded by the Big Three. Otherwise, the potential of the ombudsman's office to earn investor trust and to restore market confidence in the integrity of CRAs and their ratings is muted.

B. *Remunerating the Raters*

In order to align director and manager objectives (and avoid having them pressure analysts into submission) with the gatekeeping function of CRAs, compensation packages should not be linked to revenue or market share. It is also inappropriate to reward employees with shares or options in CRAs or CRA-related companies because policies of this kind have demonstrated unintended consequences in the CRA setting,[134] and CRA managers did prioritise market share over good work by creating and enforcing policies that jeopardised the integrity of CRAs and credit ratings.[135] Whilst analyst remuneration should not be linked to shares or scaled with revenue, an empirical labour market analysis shows that analysts had the propensity of 'jumping ship' and finding employment in investment banks and issuers during profitable periods.[136] This may be because analyst remuneration is flat whereas investment banks typically scale employee remuneration, meaning that bank employees had much to gain when their employers earned more. Analyst compensation is disproportionately low if weighed against their workload[137] and the CRA profit margin.[138] Even though Dodd-Frank restricts analysts from accepting employment from issuers which they had rated before for a period of time, CRAs may continue to face staffing shortages in the future unless analyst compensation is increased.

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[133] Shenn, above n 103.
[134] Caton above n 36, 705; Johnston, above n 33.
[135] Froeba, above n 35.
[136] Bar-Isaac, above n 79.
[137] An internal e-mail from a Big Three employee expresses concern over heavy workloads, tight timelines, acute understaffing, and compromised quality – Heski Bar-Isaac, above n 79.
[138] See, eg, Partnoy, above n 54, 14; Darcy, above n 47, 631.

C. *A Uniform Qualification Framework?*

Whilst recruiting analysts from a pool of candidates with diverse qualifications, experience, and backgrounds is generally good, there is no uniform qualification or induction program for new analysts.[139] The lack of formal training and in-depth expertise was an underlying factor which contributed to the CRA error of accepting the assumption that the complex financial products blamed for the global financial crisis were backed by traditional thirty-year mortgages.[140] We know that the credit risk and exposures in these products were in fact sub-prime, and mortgage rates were variable. A uniform qualification administered by a chartered association or professional representative body,[141] would ensure that analysts are job-ready and at a minimum, financially literate with an acceptable level of professional ethics. Such a body or association would also be in charge of disciplining members who capitulate to conflicts of interest by failing to ask searching questions. At present, no internal or external procedure exists that requires analysts to stand behind the opinions they hold or the qualitative assessments and assumptions that they make.[142] Making analysts answerable to their peers at a peer-established standard of professional practice enhances accountability, and encourages analysts to prioritising a high standard of ethical conduct over profit and market share, even if the analyst would be rewarded financially for the latter two. This can increase the integrity of credit ratings as a whole because it counteracts management pressure to adjust the criteria of ratings.

D. *Enhanced Disclosure Improves Compliance with Soft Law*

If investors continue to have no recourse against CRAs for inaccurate or negligently-issued credit ratings, more disclosure is justified. CRAs ought to be required to disclose information which affect or have the potential to affect the outcome of the ratings process. This includes information about internal quality control measures and stress tests; ratings methods, policies, and models; underlying assumptions (save for commercially-sensitive information which attract protection from insider trading laws); and factual data like the geography, size, and value of underlying exposures. Although the Big Three are privately-owned entities, their role as gatekeepers and informational intermediaries in the financial industry warrants these disclosures. Disclosure is especially important to give teeth to a recent amendment to the Securities and Exchange Act 1934

[139] See IOSCO Internal Controls, above n 112, 14-15.
[140] Mullard, above n 2, 77.
[141] For example, the Certified Financial Analyst qualification issued by the CFA Institute or one issued by a peak professional body like the Institute of Chartered Accountants.
[142] See Andrew Fight, *The Ratings Game* (Wiley & Sons, 2001), 3.

which allows investors to withstand interlocutory strike-out applications if it is properly alleged that the CRA failed to conduct due diligence on the facts relied upon or assumed in the ratings process.[143]

Principles-based governing can also be very effective given the right conditions. For example, the ASX Principles successfully improved corporate governance despite not having the force of law. The key reason for this is that compliance and enforcement happens organically. The mechanism works as follows. The ASX Principles told investors what good governance was and what it looked like, whilst ASIC required ASX-listed companies to disclose the extent of their compliance with the spirit and letter of the ASX Principles. ASIC also required a public explanation of instances of non-compliance. Companies adopted the ASX Principles in order to attract investment and compliance became a positive selling point. The combination of these factors empowered investors and shareholders to reward good behaviour by purchasing shares (raising the share price) or express dissatisfaction by 'voting with their feet' (lowering the share price). Save for ASIC disclosure requirements, regulatory intervention was not necessary in order to ensure that the ASX Principles were adopted. Whilst the IOSCO Code and IOSCO Principles mirror the concept behind the ASX Principles, the IOSCO solutions do not have the same teeth because CRAs are only required to report compliance levels to regulators such as the SEC. To remedy this, CRAs should be required to make these reports publicly available. Alternatively, CRAs should go public (discussed below).

E. *Multiple Ratings*

One author suggests that regulations should be amended to require two types of credit ratings – standard credit ratings, and 'stressed'.[144] Since a stressed rating is based on pessimistic outlooks, the argument for multi-rating regulations has merit. Firstly, it provides investors and regulators with a point of comparison. Ostensibly, a larger difference between a standard and stressed rating would indicate that the standard rating is more sensitive to extraneous stressors and as a result, it would be more prone to downgrades. This allows issuers and their counterparties to anticipate additional contractual or regulatory obligations and to earmark funds as collateral at an early stage so that another liquidity crisis can be avoided. Ratings-contingent regulations can further restrict money market and

[143] *Securities and Exchange Act 1934*, Pub L 73-291, §§ s933(b)(2), 21D(b)(2), 48 Stat 881. See also Ronald S Borod and Martin Bartlam, 'Rating Agency Reform in the EU and the US' (2012) 38(13) *Practical International Corporate Finance Strategies* 1, 4.
[144] Sarah Pei Woo, 'Stress Before Consumption: A Proposal to Reform Credit Rating Agencies' (2012) 18(1) *European Law Journal 62.*

pension funds from investing in products below a certain ‘stressed’ rating, making these protections more robust.

Whilst arguments against this idea central around the idea that a multi-ratings scheme would increase costs for the issuer, it is common practice for issuers to solicit credit ratings from at least two of the Big Three anyway.[145] CRAs may decide levy additional charges, since additional work is done, but costs may not be as prohibitive as it appears if it is already standard practice or CRAs to solicit more than one rating. In addition to the above, a multi-ratings scheme has the potential to reduce destructive competition (more competition has been shown to increase the volume of higher ratings and downgrades)[146] between the Big Three if major issuers are further required to rotate between the Big Three or other CRAs in the same way that audit partners are rotated. Firstly, this reduces the effects of relationship bias – it forces CRAs and issuers to work at arm’s length because there possibility of an extended relationship with any one agent of the CRA at any given time is extinguished. In the result, CRAs are less likely to capitulate to issuer demands and influence. Secondly, this reduces the propensity of CRAs to compete in a ‘race to the bottom’ to attract business from issuers. Under this kind of rotation, major issuers cannot stick with any one CRA for all their rating needs, so it is an eventuality that a credit rating will be solicited from other CRAs.

However, prior to implementing these changes, a feasibility study is required in order to determine whether stressed and standard credit ratings should be issued by two different CRAs (costs could potentially double) or whether it is permissible for a single CRA to issue both. If a single CRA is permitted to issue both, there must be bargaining parity in issuer-CRA relationship so that issuers cannot influence the outcome of either of these ratings. It is also imperative, in any event, that CRAs are paid upfront so that the CRA revenue does not depend on the profitability of the product to issuers. It remains that until bargaining parity is achieved, regulation needs to facilitate immediate payment.

F. *A New Office to Counteract Conflicts*

Managers have demonstrated that they had the capacity to exert a large amount of influence over analysts and their work. Lack of internal controls was largely to blame. Introducing a chain of command where analysts report directly to a chief analyst, who, in turn, sits on and reports the board, can open up channels of communication and allow analyst concerns to be addressed in a timeous manner.

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[145] Oster, above n 22, 360.
[146] Dallas, above n 115.

This addresses several conflicts of interest by ensuring that management priorities, threats, and pressures are heard. It also ensures that the board is routinely apprised about fundamental issues which concern the integrity of the CRA and its ratings, like the soundness of in-house methods, models and documentary and information-gathering policies.[147] Unlike chief executives and managers, whose mandates are to generate revenue and market share, the chief analyst's job would be to voice the concerns of analysts so that there is a forum to strengthen the integrity of the ratings process. In addition, this new office is well-suited to the task of analysing the accuracy of past ratings, conducting reviews, and recommending changes to ratings-related methods, policies, and models,[148] which remain a key criticism of CRAs and their credit ratings.[149]

G. *Going Public?*

Even though CRAs are privately-owned firms, they have quasi-regulatory powers if the significance of credit ratings is considered. Credit ratings serve a public purpose since they determine the ambit of regulatory and contractual obligations. Credit ratings affect an issuer's cost of capital and influence investor decisions.[150] In effect, the NRSRO framework outsourced a regulatory licencing regime to CRAs.[151] Since the majority of the problems with the Big Three stem, in one way or another, from their ownership structure, it is suggested that NRSRO regulation compel the Big Three (and other NRSRO-registered CRAs) to go public. Opening up CRA ownership has several consequences, good and bad. The primary improvement is that internal governance of CRAs will be forced to improve. As discussed above, public companies have onerous disclosure obligations and it was these disclosures that enabled investors to hold company governors accountable. These disclosures can trigger an organic enforcement mechanism where the need to attract investment would incentivize CRAs to comply with the spirit of principles-based regulation. As a result, compliance with the IOSCO Codes and Principles will set the gold standard and investors can enforce compliance in several ways. First, CRA shareholders can requisition extraordinary general meetings in order to hold the board of directors accountable and compel them to address poor governance and the deficiencies in their explanations for non-compliance with the IOSCO Codes and Principles. Second, shareholders have influence over CRA remuneration schemes and can pressure that the relevant remuneration committees to structure compensation

[147] Mullard, above n 2, 77, 85, 89.
[148] Miglionico, above n 5, 75.
[149] Malkovic, above n 66, 16; Rom, above n 48, 645.
[150] See, eg, Rom, above n 48, 641.
[151] Andreas Kruck, *Private Ratings, Public Regulations. Credit Rating Agencies and Global Financial Governance* (Palgrave Macmillan, 2011), 5.

packages that promote the integrity, independence and objectivity of the ratings process. Third, dissatisfied owners can sell their shares in the CRA to express dissatisfaction with the way it is governed. This can cause the CRA's share price to fall, countenancing CRA employees for poor governance and practices and providing shareholders and users of credit ratings alike with a fair indication of the quality of that CRA's credit rating. If CRAs went public, it would be a fairly simple task to check if a downward spike in share price was caused by poor governance and compromised standards rather than other factors, since CRAs have to disclose their IOSCO compliance levels to the public instead of the SEC.[152]

In the same way, shareholders can hold individual CRA directors, managers and executives accountable for bad governance, skewed remuneration policies, and inaccurate ratings. This provides CRAs with a compelling reason to conduct rigorous ratings and reviews – something that CRAs omitted to do so because of the lack of incentives and disincentives.[153] Fourth, this counteracts the risk that complacence may arise as a result of immunity from civil litigation – directors, officers, and the CRA as a whole are accountable to shareholders and can be sued for negligence or breach of duty without triggering statutory restrictions. A corollary is that this liability can have a deterrent effect on CRAs engaging in ancillary, conflicting businesses.[154] Public listing provides CRAs with alternative sources of funding and reduces a CRA's dependence on fees from issuers in order to survive.[155] Regardless of the fee model employed, going public can reduce CRA reliance on fees and market share for revenue and avoid triggering the conflicts of interest related to fees and market share.

A primary difficulty with this approach is this: why would CRAs go public if there risks and liabilities outweigh the benefits for CRA owners? After all, the Big Three would have gone public a long time ago if this was a desired prospect. Coercion is required, because there is no financial impetus for CRA owners to do so on their own. Unless regulatory reliance on CRAs is completely eliminated, CRAs continue to be profitable enterprises and profit margins remain high because demand is guaranteed. Thus, CRA owners will be reluctant to part with their ownership. A further complication is that CRA owners are themselves publicly-owned companies, which means their own share price may be negatively affected if CRAs went public. This idea is still in infant conceptual stages.

[152] SEC Summary of CRA Issues, above n 44, 646.
[153] See, eg, Rom, above n 48, 645.
[154] See, eg, Strier, above n 45, 544.
[155] SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market' (January 2003), 23, 50-51.

However, if regulators decide to take this path, a comprehensive study on ownership structure (for example, on whether different types of shares should be offered, whether there should be restrictions on who can buy the different types of shares to prohibit participation from typically short-term owners like hedge funds, how voting rights are structured) is needed.

As is typical of the legislative process, there will be various forms of inertia and resistance against the concept of compelling CRAs to go public. As at this time, making CRAs public has not been discussed amongst regulators, and scholarly articles examining the feasibility of this solution are few. This paper could only find a single piece of academic literature which, although it does not advocate as this paper does for the Big Three to go public, discusses the potential framework and consequences of a single, new, public CRA.[156] The principal weakness of a single, new public CRA (international or otherwise) cannot be understated. Without the same intrusive regulatory measures required in forcing the Big Three to go public, it is not possible to anchor the public CRA as anything more than an alternative or second preference to Big Three credit ratings. It would also incur a great expense and funding by the public purse to do so. However, this article does provide a foundation for further critical and academic debate.

H. *All About Arbitrage*

The above suggestions require legislative action. A key concern with that is regulatory competition and arbitrage. Regulatory arbitrage is where firms optimise their structure or activities to take advantage of the differences between regulations in two different countries. It is a very real concern for regulators, chiefly because regulatory arbitrage creates regulatory competition, or competition between countries to create the most business-friendly environment to retain liquidity within domestic borders.[157] This instigates competition between politicians and regulators because each has a different concern. Regulators may be concerned with the efficacy of the domestic regulatory framework, but politicians have to consider the overall consequences of making laws more stringent. Obligations which are too many or too onerous may drive businesses, and correspondingly, investment, to go overseas. Over-regulation is costly. Besides discouraging business by diverting liquidity away from investment into compliance, the risk runs that the cost will be passed on and borne by investors in the end. Arbitrage and competition of this kind can only be addressed by

[156] Susan Schroeder, 'A Template for a Public Credit Rating Agency' (2013) 47(2) *Journal of Economic Issues* 343.

[157] For a study of one instance of regulatory arbitrage, see Anupam Chander and Randall Costa, 'Clearing credit default swaps: a case study in global legal convergence' (2010) 10(2) *Chicago Journal of International Law* 349.

creating a uniform regulatory framework worldwide, which is difficult to implement and enforce. Even ostensibly minute differences between national implementations can create enough of an incentive for businesses to move elsewhere.[158]

V. Conclusion

Whilst the problems which arise from the present CRA framework are not new, they are complicated. CRAs have been trusted to self-govern for too long. The justifications for allowing them to do so are now outdated and inapplicable. Given the continued use of credit ratings as reference points in regulatory and private contract credit risk assessments, it is imperative that the CRA framework is revisited given the events that unfolded and the practices revealed during the global financial crisis. Although there have been initiatives on the part of the Big Three to address the governance deficiencies discussed in this paper, these initiatives are inadequate for the reasons discussed above. It remains that the integrity of credit ratings is still susceptible to issuer influence given CRA reliance on fees and the lack of bargaining parity in the issuer-CRA relationship. There is no mechanism to hold CRAs accountable for the integrity of their ratings methods, outcomes, and policies. Correspondingly, there is no impetus to improve because CRAs are private profit enterprises. In the circumstances, regulatory and legislative intervention is justified. However, the importance of a uniform regulatory framework must be noted given the global reach of the financial markets and the public nature of (and access to) credit ratings. National regulators need to work towards improvement in concert to eliminate the risk of regulatory arbitrage and reduce the effects of regulatory competition.

[158] For example, in the EU, central clearing counterparties are not required to trade or clear electronically whereas they must do so in the USA. This means that initial start-up costs for central clearing counterparties in the USA is much higher even though there are many forensic auditing benefits that come from electronic clearing. See, eg, Chander, above n 157.

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