PANTEION UNIVERSITY OF SOCIAL AND POLITICAL SCIENCES
Department of International, European and Area Studies

M.A. in International and European Studies
Specialization: International Business Law and Economics

M.A. Thesis:

The Rationale for the Regulation on Credit Rating Agencies: Global and EU Responses

by

Dimitrios Bezaintes

Thesis Supervisor: Professor Christos V. Gortsos

MARCH 2016

ATHENS

Introduction

Although having been established since the dawn of the 20th century, Credit Rating Agencies (CRAs) had been, for the most part, neglected by regulators worldwide. Before the global financial crisis of 2007-2009, few had commented on them and even fewer had agreed on attempts to regulate their functions. This might come as a surprise, given CRAs' key role on the development of global financial markets. They are indeed the only companies that are naturally and inevitably involved in all major fields of financial markets; banking, securities and capital markets. Contrary to regulation, either strict or more flexible, on all three of the above, CRAs had the privilege to provide their services outside a legal framework for as long as a century. Furthermore, as states participate in capital markets by issuing Government Bonds, CRAs are also involved in fiscal solvency.

The need for regulation on CRAs has emerged only recently, as legislators worldwide realized the key role of CRAs in global economy. This was undoubtedly proposed after the 2007-2009 financial crisis. It was then that CRAs were accused of being in the very center of the financial meltdown, due to their "failed" ratings either of insolvent financial institutions (e.g. Lehman Brothers) or of complex capital instruments (e.g. mortgage-related securities), along with their "failure" to properly inform the clients who relied on them of the risks they were taking.

Moreover, the three major CRAs were the first to officially "announce" to the world the upcoming sovereign debt crisis in certain states of the euro area by downgrading their Government Bonds ratings. As some of these states still struggle to overcome the ongoing fiscal crisis, CRAs ratings have become even more crucial. Greece's creditors, for example, partly rely on ratings in order to decide the appropriate method of funding the State. As a matter of fact, it is now profane on both sides of the Atlantic that CRAs should be subjected to regulation and supervision.

The paper proceeds as follows: In Section A an outline of the credit rating industry and the reasons that lead to the universal demand for regulation on CRAs are provided. In Section B the key standards of the international fora concerning the functioning of CRAs are discussed, along with an outline of the American legislation on CRAs. In Section C the European responses to the need for regulation on CRAs are included in the discussion, through a description of the CRA Regulation and the role of the European Securities and Markets Authority as supervisor of the CRAs in the EU. Finally, in Section D the effectiveness of the current regulatory framework on CRAs is assessed.

TABLE OF CONTENTS

SECTION A: THE RATIONALE FOR THE REGULATION ON CREDIT RATING AGENCIES 1

I. Historical Background and Evolution of the Credit Rating Industry 1
1. History of the Credit Rating Agencies 1
2. Definition of Credit Ratings 2
3. The Role of Credit Ratings and Credit Rating Agencies in Modern Finance Markets 3
4. The Credit Rating Industry Nowadays 4

II. Critique on Credit Rating Agencies 5
1. The Rise and Fall of the Reputational Capital Theory 5
2. Inherent Problems of the Credit Rating Industry 7
2.1. Lack of Competition 7
2.2. Conflicts of Interest 7
2.3. Quality of Ratings 8
2.4. Lack of Transparency 8
2.5. Lack of Accountability 8
2.6. Rating-Dependent Regulation 9
2.7. American Business Ideals 9
3. The Role of the Credit Rating Agencies in the Global Financial Crisis 9

SECTION B: GLOBAL RESPONSES FOR THE REGULATION ON CREDIT RATING AGENCIES 15

I. IOSCO Soft Law on Credit Rating Agencies 15
1. IOSCO CRA Four Principles (2003) 15
2. IOSCO CRA Code (2004, 2008) 15
3. Revised IOSCO CRA Code (2014) 16

II. FSB Soft Law on Credit Rating Agencies 17
1. FSB Principles for Reducing Reliance on CRA Ratings 17
2. FSB Roadmap and Thematic Review 19

III. American Responses: Regulation of the Credit Rating Agencies in the U.S. 19
1. Regulation Background (1909 - 1970) 19
2. Credit Rating Agencies as Nationally Recognized Statistical Rating Organizations 20

3. Credit Rating Agency Reform Act (2006) 22

4. The American Response to the Crisis: Dodd-Frank Act (2010) 24

4.1. Supervision and Transparency 25

4.1.1. Conflicts of Interest 26

4.1.2. Disclosure 28

4.2. Civil Litigation against Credit Rating Agencies 29

4.3. Reliance on Credit Ratings 32

SECTION C: EU RESPONSES FOR THE REGULATION ON CREDIT RATING AGENCIES 37

I. Evolution of Legislation: from the de Larosière Report to the Regulation on Credit Rating Agencies 37

1. Preliminary Thoughts on Adopting Rules on Credit Rating Agencies 37

2. Regulation 1060/2009 (CRA I) 38

3. Regulation 1095/2010 and the Establishment of ESMA 39

4. Regulation 513/2011 (CRA II) 39

5. Regulation 462/2013 (CRA III) 40

II. Use and Certification of Credit Ratings for Regulatory Purposes 41

1. Use of Credit Ratings 41

2. Equivalence and Certification Based on Equivalence 42

III. Independence and Avoidance of Conflicts of Interest 43

1. Organizational Requirements concerning Conflicts of Interest 43

2. Operational Requirements concerning Conflicts of Interest 44

3. Requirements for Rating Analysts and Employees of the Credit Rating Agencies 44

4. Exemption from Requirements concerning Conflicts of Interest 45

5. Conflicts of Interest concerning Investments in Credit Rating Agencies 45

IV. Rules on the Issuing of Credit Ratings 46

1. General Rules on Credit Rating Methodologies, Models and Key Rating Assumptions 46

2. Rules on Sovereign Ratings 46

3. Rules on Ratings on Structured Finance Instruments 47

V. Transparency and Disclosure Requirements 47

1. Presentation of Credit Ratings 47

2. The European Rating Platform 49

3. Specific Disclosure Requirements 49

VI. Surveillance of Credit Rating Activities 49

1. Registration of Credit Rating Agencies 49

2. Application for Registration 50

3. Examination of the Application for Registration 50

4. Withdrawal of Registration 51

VII. Supervision of Credit Rating Agencies by ESMA 51

1. ESMA as Supervisor of the Credit Rating Agencies 51

2. Requests for Information 52

3. General Investigations 53

4. On-site Inspections 54

5. Procedure for Taking Supervisory Measures and Imposing Fines 54

6. Supervisory Measures by ESMA 55

7. Penalties, Fines and Periodic Penalty Payments 56

7.1. Penalties 56

7.2. Fines 56

7.3. Periodic Penalty Payments 57

7.4. Disclosure and Enforcement of Fines and Periodic Penalty Payments 58

VIII. Civil Liability of Credit Rating Agencies 58

IX. Towards Reducing the Reliance on Credit Ratings 59

SECTION D: CONCLUDING REMARKS **63**

Primary Sources 67

Secondary Sources 69

Section A: The Rationale for the Regulation on Credit Rating Agencies

I. Historical Background and Evolution of the Credit Rating Industry

Since the publication of Moody's "Analyses of Railroad Investments" in 1909, credit rating agencies (CRAs) have become central institutions in financial markets. They emerged to rectify some of the information asymmetries that exist in lending relationships. Throughout the last century, CRAs have adapted to ever evolving financial markets. Initially focused on railroads, industrial corporations, and financial institutions, CRAs now rate every type of issuer, both national and international. Ratings cover traditional fixed-income securities, such as bonds, as well as new structured finance instruments such as asset-backed securities. Increasingly, the opinions of CRAs have come to carry more importance for market participants. Regulation has frequently relied on ratings, too. Aside from that, market participants rely on ratings not necessarily because the CRAs are right, but because they are thought to be an authoritative source of judgments[1].

1. History of the Credit Rating Agencies

The precursors to 20th century CRAs were mercantile credit agencies[2]. During the 17th and 18th centuries, colonial importers customarily extended up to a year of credit to their retail customers, shopkeepers, and general stores. Payments were often late, and it was difficult for sellers to gather credible information about the reputation of buyers. As markets and trade evolved during the 19th century, it became clear that there were economies of scale associated with gathering and disseminating credit information in a systematic, organized way.

One of the victims of the crisis of 1837 was Lewis Tappan, who operated a substantial silk business. He also kept detailed credit information about current and prospective customers, which included many large commercial enterprises. When the silk business collapsed, that customer information proved valuable to other merchants, and in 1841, Tappan formed "The Mercantile Agency", the first mercantile credit agency. As Tappan and other mercantile credit raters thrived during the late 1800s, other raters began to copy Tappan's idea, particularly in rating investments in stocks and bonds.

In the latter part of the 19th century, railroad construction and development became the largest and most capital-intensive industry in the U.S. The railroad industry became the primary focus of many investors, and the financing of its construction and development fostered the growth of the capital markets. Railroad information was at a premium for several reasons; it was costly to gather, difficult to interpret and often inaccessible to the public[3]. The demand for information about this expanding industry was enormous and unprecedented. These conditions created a perfect marketing opportunity for those who were able to compile, interpret and disseminate this information.

Henry Varnum Poor was the first to capitalize from such information gathering when he published the "History of Railroads and Canals in the U. S." in 1860. It was a compilation of statistical data concerning the financial and operating results of the railroads and the railroad industry. In 1868, Henry and his son William published "Poor's Manual of Railroads", which provided information about investing in railroad companies. The manual was updated

[1] Rousseau, p. 621

[2] Partnoy (1999), pp. 636-637

[3] Wolfson/Crawford, pp. 85-87

annually and sold to investors allowing them to chart and track the changes in their railroad company's progress. Another pioneer to board the "information railroad" and capitalize from selling railroad information was Luther Lee Blake. He established the "Standard Statistical Bureau" in 1906 and began publishing financial information about the railroad industry. In 1941, Standard Statistics merged with Poor's Publishing Company to form Standard & Poor's Corporation. Standard & Poor's was acquired by McGraw-Hill Companies in 1966.

In 1909, John Moody joined the rating business when he published his first "Manual of Railroad Securities", in which he rated the credit quality of two hundred railroad companies. Moody was the first to assign letter grades to the companies and its securities in a declining order of credit quality. These ratings devised by Moody were not designed to have any specific meanings as might be the case for modern financial analysis. For example, they were not designed to mark categories of expected percentages of expected probability of default. Instead, they were rough compilations of disparate information about bonds that investors found too difficult or costly to assemble on their own. In 1914 Moody's Investors Services was created, and, within a decade, the company was providing ratings for nearly all government bond markets. By 1970 Moody's had emerged as a full-scale CRA.

In 1913, John Knowles Fitch established the Fitch Publishing Company that sold statistical and financial analysis to the public in the "Fitch Bond Book" and "Fitch Stock and Bond Manual". In 1924, Fitch introduced the now familiar AAA through D ratings that ultimately became the benchmark by which the financial community based fixed income investment decisions. In the late 1990's, Fitch Publishing Company merged with IBCA of London and acquired market competitors Thomson Bank Watch and Duffs and Phelps Rating Agency to become a full service global rating agency. It is presently owned by a French conglomerate, FIMALAC, and is an amalgam of several smaller agencies[4].

2. Definition of Credit Ratings

A credit rating is an assessment of the creditworthiness of a corporation or security, based on the history of borrowing and repayment for the issuer, its assets and liabilities and its overall business performance. Credit ratings are opinions on the creditworthiness of corporations, governments, countries, and the securities issued by these entities. Ratings are not mere calculations; they are judgments made by committees and it is not clear if quantitative or qualitative data prevail in the assignment of ratings by these committees[5]. Thus, they are not precise measures of default risk, but instead facilitate comparisons across issuers by means of standardized risk categories.

A credit rating consists of a letter that corresponds to a given probability of default, usually accompanied by a text rationale. Those letters may range from AAA to D. While each CRA defines its own rating categories (notches), the correspondence between the different CRAs' notches is well understood by market participants. For S&P and Fitch, AAA is the highest rating, followed by AA, A, BBB, BB, B, CCC, CC, C, and D, with D designating an instrument that has defaulted. For Moody's, Aaa is the highest rating, followed by Aa, A, Baa, Ba, B, Caa, Ca, C. Ratings often are modified by a suffix such as "+" or "-", creating finer gradations. The best rating possible is AAA/Aaa; an investor can rest almost completely assured that an instrument rated AAA/Aaa will pay principal and interest as scheduled. Any

[4] Hill, p. 46
[5] Marandola/Sinclair, p. 2

rating between AAA/Aaa and BBB-/Baa is investment grade; the CRA thinks that the obligor has at least a good, if not an excellent, capacity to repay principal and interest on the instrument as and when due. Any debt instrument rated below BB/Ba is considered speculative grade or "junk"[6].

There are two main types of ratings; bond ratings are provided for a vast majority of publicly-traded bonds, while firm (or issuer) ratings are produced for public firms that issue public debt. Credit ratings may be publicly available or require subscription; CRAs may charge investors or issuers according to their business model. The three principal CRAs adopted an issuer-pays model in the late 1960s and early 1970s, and provide free access to their ratings, although they charge for additional information. Since then, their revenues derive from charges to the firms whose credit quality is being assessed. Fees for bond ratings typically consist of a fixed fee per year coupled with a larger upfront fee which is charged when the bond issue is first rated at time of issuance. Paying for firm ratings is voluntary, although raters will only consider non-public information provided by the firm itself if they receive payment from the corporate issuer[7].

Furthermore, a credit rating may be solicited or unsolicited; the former is sought by the issuer and implies cooperation between the two parties, while the latter is issued at a CRA's initiative and relies mostly on public information and information internal to the CRA. When the rating is solicited, the CRA analyzes the environment in which the issuer operates and considers firm-specific information obtained through the interaction with managers. Rating analysts recommend a rating to a rating committee of senior agency staff, who determine the rating. The process lasts around a month and the rating is revised once a year or earlier if any particular developments occur.

In addition to ratings, CRAs also announce outlooks, reviews and credit watches. Outlooks reflect CRAs' prognosis (positive, negative or stable) regarding the likely direction of an issuer's credit quality over the medium term, usually over a twelve to eighteen month horizon. They are typically modified when a change in an issuer's risk profile has been observed but it is not yet regarded as permanent enough to warrant a new credit rating. Besides, a change in outlook does not always lead to a change in rating. Reviews and credit watches are synonymous; both give a stronger indication than outlooks of future changes in ratings. The rating of issuers placed on review for an upgrade or downgrade is typically changed within weeks of the review. CRAs at times change ratings without any prior announcement of a change in outlook or a review.

3. The Role of Credit Ratings and Credit Rating Agencies in Modern Finance Markets

Credit risk, i.e. the uncertainty of a lender as to whether a borrower will repay a loan is a central issue in finance, arising from asymmetry of information between the two as the latter usually knows more about the prospects for repayment than does the former[8]. Thus, credit risk assessments are necessary; lenders attempt to gather extensive information about prospective borrowers, so as to try to determine which are the more creditworthy. Moreover, they want to monitor the borrowers' actions, so as to be reassured that these are not putting repayment in jeopardy.

[6] Hill, p. 48
[7] Becker/Milbourn, p. 7
[8] White, pp. 4-6

In the wider financial market context, credit ratings have an important function: they allow investors to get to know issuers and their plans[9]. After collecting information about bond issuers, CRAs offer assessments about the creditworthiness of bonds that are issued by corporations, governments, and securitizers of loans. Those assessments are in the form of ratings and help in reducing the asymmetry of information between investors and issuers and encourage the allocation of funds to the best entrepreneurs. Furthermore, credit ratings provide the possibility of monitoring of managers and government officials, as the threat of a ratings downgrade may encourage these persons to act in the interests of bondholders rather than themselves (principal-agent problem). Finally, ratings may act as a governance tool by influencing issuers' financing strategies; when evaluating debt issuance decisions, firms take into account the potential impact of those decisions on their credit ratings. Indeed, the cost of debt is highly correlated with credit ratings, making firms extremely keen to maintain their ratings at the highest possible level. All in all, credit ratings comprise an important part of the infrastructure of capital markets.

After the crash of 1929, the landscape changed significantly as regulators began looking for an expression of safety and assurance from the CRAs. They became increasingly reliant on credit ratings and opinions concerning the quality of investment portfolio holdings, investment compliance guidelines and expertise in assessing bond issue quality. As a result, regulators transformed rating agencies from information brokers to "gatekeepers" to the financial markets. Regulatory reliance on credit ratings transformed these informational opinion-based databases to required "seals of approval" for those companies needing access to the capital markets. Thus, access to capital markets became increasingly difficult without the quality assurance from the CRAs[10].

Consequently, ratings have become increasingly used by regulators, banks, bondholders, pension fund trustees and other fiduciary agents in the form of investment management guidelines[11]. In this sense, CRAs can be considered as important actors for the fact that they are a part of the internal organization of the market itself. The fact that people view them as important, and act on the basis of this understanding in markets, means that markets and debt issuers have strong incentives to act as if participants in the markets take the CRAs seriously. Oftentimes, traders refer to a company as an 'AA company', or some other rating category, as if this were a fact, an uncontroversial way of describing and distinguishing companies, municipalities or countries. What is central to the status of CRAs is what people believe about them; if people use credit ratings as a guide to action, they are significant[12]. As a result, the significance of ratings in today's global economy derives not only from the ideas or information conveyed, but also from the various social, financial, and legal institutions that favor CRAs' opinions by attaching various financial and regulatory consequences on their ratings[13]. Put differently, CRAs might simply tell the market what it already knows, and yet their opinions continue to have impact.

4. The Credit Rating Industry Nowadays

---

[9] Marandola/Sinclair, pp. 2-3
[10] Wolfson/Crawford, pp. 86-87
[11] Cantor/Gwilym/Thomas, p. 3
[12] Ibid., p. 4
[13] Bruner/Abdelal, p. 200

CRAs may operate at a national, regional, or even global scale. Some provide ratings on a limited number of issuers while others have the capability of rating all issuers in a given marketplace. The three largest CRAs operating on a global scale are Moody's, Standard & Poor's (S&P), and Fitch. Moody's and S&P have a combined market share in excess of 80%, while Fitch's market share is approximately 14%. All three are based in the U.S. There are a number of other rating agencies, both general purpose and specialized, but, as the above numbers suggest, they are quite small.

The market position of Moody's and S&P is evident. Issuers typically attempt to obtain both Moody's and S&P ratings, and very occasionally use Fitch as a third rating. Fitch may, for instance, be used for a third rating if Moody's and S&P disagree. It is rare that Fitch is used as a second rating, and even rarer that it is used as the only rating. There is, in effect, a two-rating norm[14]. Anyway, Moody's and S&P do not need to compete with each other for business in their traditional markets; given the fact that issuers typically get ratings from both, neither can realistically supplant the other. Their high profit margins may suggest that they do not compete much on price either. Fitch, by contrast, competes quite aggressively. One strategy has been to carve out a niche for itself in structured financing; its market share in structured finance instruments is far higher than its market share for traditional bond issuances [15]. Another strategy might be to compete on price and some related non-price terms.

Aside from providing credit ratings, CRAs also offer ancillary services. These services include rating assessment services, whereby they provide an evaluation of the impact of contemplated corporate action on an issuer's rating. Other services include risk management and consulting services designed to assist financial institutions and other corporations in their management of credit and operational risk[16].

Finally, although CRAs traditionally earned their revenues from subscriber fees paid by investors, in the early 1970s, CRAs changed their business model and started charging issuers for their rating services. Nowadays, the larger CRAs derive most of their revenues from the fees charged to issuers.

II. Critique on Credit Rating Agencies

1. The Rise and Fall of the Reputational Capital Theory

Economists note the value of reputational capital in sustaining a self-policing society[17]. Individuals acquire reputations over time based on their behavior. If an individual's reputation improves, and other members of society begin to hold that individual in higher esteem, that individual acquires a stock of reputational capital, a reserve of good will, on which other parties rely in transacting with that individual. Reputational capital leads parties to include trust as a factor in their decision-making; trust enables parties to reduce the costs of reaching agreement. Reputational capital is especially valuable when a small number of actors interact repeatedly. In such situations, cooperation among individuals can prevail even without a government authority, as players learn information about other players' strategies. Reputational capital and ratings are closely related. Rating services survive and prosper based on their ability to acquire and retain reputational capital. Raters who invest more in their

---

[14] Hill, p. 60

[15] Ibid., p. 61

[16] Rousseau, p. 624

[17] Partnoy (2006), pp. 628-629

investigative and decision-making processes acquire greater reputational capital. Individuals and institutions look to a rater's accumulated reputational capital in deciding whether to rely on the assessment of this rater or, instead, to undertake independent investigation.

Reputational capital and credit ratings are even more closely related, for two reasons[18]. First, the concept of credit, broadly defined as the promise to pay in the future, includes notions of trust and credibility. In a market economy, financial markets allocate the supply of and demand for credit, and thereby determine the price of various types of credit risk. Lenders make lending decisions based on the perceived riskiness of borrowers. Both lenders and borrowers consider trust and credibility: the credit risk a lender perceives depends in large part on the reputation of the borrower. Second, the success and function of CRAs also depend on trust and credibility. Each CRA depends for its livelihood on its reputation for objectivity and accuracy. Credit ratings respond to investors' demand for information about risks associated with investments. By specializing in the gathering, analysis, examination, and dissemination of such information, CRAs eliminate the efforts of individuals engaging in such activities. Thus, credit ratings are a competitive, reputation-driven business, and CRAs should survive only to the extent they are accurate and reliable in assessing the credit risks of borrowers.

Information-gathering agencies may acquire and process information for the purpose of certifying asset quality. Three criteria must be satisfied for certification to be credible to outside investors[19]. First, the certifying agent must have reputational capital at stake in the certification activity. In other words, the certifying agent would suffer a loss of future relationships because of reduced trustworthiness if it suggested a fair market value in excess of the offering price. Second, the loss in reputational capital must exceed the gain possible from false certification. Third, the agent's services must be costly and the cost must be related to the asymmetric information associated with the issuing firm. According to the reputational capital view of CRAs, these three criteria are satisfied. First, CRAs have reputational capital at stake in issuing ratings. Second, they would lose more in reputational capital from giving false ratings than they would gain in increased fees. Third, ratings are costly, but are also needed to overcome information asymmetry between issuers and investors.

In this way, CRAs seem to function as gatekeepers, i.e. as professionals who are positioned so as to be able to prevent wrongdoing by withholding necessary cooperation or consent[20]. Gatekeepers typically have reputational capital that can be pledged or placed at risk by the gatekeeper's vouching for its client's assertions or projections. This indicates that gatekeepers have an important incentive to comply with their duties, namely protecting the value attached to their own reputations. Applied to CRAs, this means that it is in their own best interest to ensure the integrity of their ratings, as their ratings will not be valued otherwise.

It appears that, at least when they first appeared, CRAs functioned in a manner consistent with the reputational capital view described above[21]. They served as an information intermediary and ratings became a pricing mechanism for information. In general, bond investors supported and welcomed ratings during this period. CRAs published accurate and reliable ratings and

[18] Ibid., p. 630
[19] Ibid., p. 632
[20] Lombard, p. 2
[21] Partnoy (2006), pp. 639-640

thereby increased their stock of reputational capital. CRAs continued to accumulate reputational capital during the 1920s because they were able to gather and synthesize valuable information. During this time, ratings were financed entirely by subscription fees paid by investors, and the CRAs competed to acquire their respective reputations for independence, integrity, and reliability. In a market with low barriers to entry, a CRA issued inaccurate ratings at its peril; its name, integrity, and credibility were subject to inspection and critique by the entire investment community. Furthermore, CRAs continued to accumulate reputational capital during the 1930s and they became much more important to both investors and issuers during this period. In the years following the stock market crash of 1929, demand for credit ratings increased, as investors became concerned about high bond default rates and credit risk. Notwithstanding the large number of ratings changes in the early 1930s and the considerable lag between the time market prices incorporated negative information about bonds and the time credit ratings incorporated such information, ratings continued to be a respected and important institution in the bond market[22].

As quickly as CRAs were able to accumulate reputational capital during their rise of the early 1930s, they just as quickly wasted such capital during the following years[23]. As a result, CRAs did not remain important or influential for long and they experienced austerity and contraction during the 1940s and 1950s. During this period, bond prices were not volatile, the economy was healthy, and few corporations defaulted. As a consequence, the demand for relevant credit information diminished. However, as the financial market expanded rapidly during the 1960s, investors were not very precise in assessing credit quality. In the fallout of the 1970 Penn Central default, investors began demanding more sophisticated levels of research. CRAs were not anymore in a position to satisfy this demand. Although they had acquired excellent reputations since the early 1900s, by the 1970s, bond ratings did not actively determine, but instead simply mirrored, the market's assessment of a bond's risk.

However, the actual credit rating industry has the potential to undermine reputational incentives. First, the industry operates in a regulatory regime that gives certified CRAs the power to sell cost-reducing and demand-increasing regulatory compliance to issuers. The regulatory component of credit rating value gives issuers an incentive to purchase untrustworthy ratings even though investors would not value them for their informational content. Second, regulatory and market factors may increase the short-term profitability of falsifying ratings or diminish the long-term profitability of reputation-building, distorting the balance of incentives necessary to promote CRA's investment in reputation. Building a reputation is a slow process that requires foregoing certain near-term profits for larger but uncertain long-term profits. CRAs fearing an impending market collapse, a regulatory crackdown, increased competition, or any other factor that would diminish the prospect of future economic rents, have less incentive to invest in reputation, and may even be induced to jeopardize their reputations[24]. Concern about the failure of the CRAs to generate accurate and reliable information during a time of crisis led to the first public arguments for regulation of the credit rating industry[25].

2. Inherent Problems of the Credit Rating Industry

[22] Ibid., p. 643

[23] Ibid., p. 646

[24] Bonewitz, p. 400

[25] Partnoy (2006), p. 647

There are several aspects of the rating market that arguably cause it to perform less well than it could. These include lack of competition, conflicts of interest, poor quality of ratings, absence of transparency, lack of accountability, rating-dependent regulation, and the fact that the major three CRAs are based in the U.S.

2.1. Lack of Competition

Moody's and S&P have an effective duopoly in the rating market with a market share of close to 80%. This could be attributed to regulators' method of regulating entry into the credit rating market, as well as to the operation of the market itself. On the one hand regulators' effort to ensure the quality of CRAs that enter the market is understandable. On the other hand, the lack of competition raises the concern that CRAs have little incentive to upgrade their services and that it could contribute to general leniency.

One way to address this problem would seem to be to open up the market for new CRAs by changing the way in which entry into the market is regulated. However, such a step may have a number of negative spin-offs, as issuers of debt might start shopping for favorable ratings where they have many CRAs to choose from. Another negative side-effect of such a step could be that a larger number of smaller CRAs will lack the basis that is required to make effective comparisons, which a large, reputable CRA who rates a large number of bond issues has. Ultimately, the entry of more CRAs into the market might as well result in ratings of poorer quality[26].

2.2. Conflicts of Interest

Since their inception, CRAs relied on an investor-pays model wherein investors subscribed to ratings released by the CRAs and these subscription revenues were their main source of income. However, because of the "public good" nature of ratings, in 1975 the concept of NRSROs was introduced, under which an issuer's access to the capital markets was made impossible without the "regulatory licenses" of these CRAs[27]. The business model, revenue structure and customer base changed dramatically; CRAs stopped selling their ratings to investors and began selling their ratings to companies whose debt was subject to rating ("issuer-pays" business model)[28].

This new model created significant inherent conflicts of interest, namely the challenge for NRSRO's to remain neutral while rating the companies that were generating their revenue. When a rating is solicited, it is less clear whether the CRAs ultimately serve the investing public or the rated, paying entity. Large CRAs receive most of their revenue from fees paid by issuers, and issuer-paid ratings represent 98% of ratings produced[29]. After an instrument is rated, the issuer can decide whether or not that rating will be published (issued) and CRAs are only paid if the rating is in fact issued.

Moreover, CRAs have begun providing advice for a fee to companies looking to improve their ratings. This creates additional conflicts of interest[30]. For example, if a company follows the CRA's advice, the CRA may be tempted to issue the company a higher rating. Such

[26] Lombard, p. 4
[27] Camanho/Deb/Liu, p. 2
[28] Wolfson/Crawford, p. 86
[29] Bahena, pp. 18
[30] Ibid., p. 19

practices would make CRA advice very valuable to companies looking to improve their ratings. CRAs attempt to avoid this conflict of interest by rating in teams and by separating their rating divisions from their advising ones.

2.3. Quality of Ratings

CRAs have also been criticized for the thoroughness of analyses conducted by rating analysts, as well as the training and qualification of these analysts. Shortcomings that can be identified in the rating process include the lack of transparency in it, which resulted in the inability of the market to understand the bases of ratings of certain structured products. Even more worrying is the fact that there is often limited or even no independent review or due diligence conducted by the CRAs to confirm whether the information provided to them in connection with assets underlying structured securities is correct[31].

Considering CRAs as gatekeepers who highly value their reputational capital, it would seem surprising that they would not take more care to produce ratings of high quality. One could assume that this indicates that reputational capital is not as highly valued by CRAs as other gatekeepers. This could be caused by the fact that there is a lack of competition in the rating industry, along with the possibility of an artificial demand created for ratings through regulation. As a result, there is little incentive for CRAs to improve their services and the general overall quality of their ratings.

2.4. Lack of Transparency

To further analyze the topic of transparency, it incorporates two types of transparency: Methodological transparency (i.e. an outsider's ability to tell just how the CRAs reach the ratings they award) and performance transparency (i.e. the ability to discern how well the ratings perform)[32]. Performance transparency, at least, seems clearly important for the reputation mechanism to work.

Although CRAs provide information on their rating methodologies, and the press release that accompanies a rating typically lists the key assumptions upon which a rating is based, many specifics, such as the qualitative analysis that goes into the ratings, go largely unreported. Moreover, CRAs do not adequately disclose the level at which they are monitoring an existing rating, nor when, whether, and why they consider altering that rating. Arguably, if more information were available about the inputs, analysis, and monitoring of each rating, market participants would be able to make more informed decisions regarding the rated instrument or entity.

2.5. Lack of Accountability

Furthermore, there seems to be a general lack of accountability on the part of CRAs when they produce defective ratings[33]. CRAs are only subject to the general liability regime, the application of which would prove very difficult for investors. Thus, potential liability would not significantly affect the behavior of CRAs. Furthermore, CRAs are traditionally afforded the protection of the First Amendment in the USA, as their ratings are regarded to be opinions. Therefore, they are not liable for negligent misrepresentations, but only for misrepresentations that result from reckless conduct.

---

[31] Lombard, p. 6

[32] Hunt, pp. 22-23

[33] Lombard, p. 7

2.6. Rating-Dependent Regulation

Credit ratings are incorporated into financial regulation and into private contracts and investor guidelines. This creates a source of demand for ratings that is not tied directly to their quality; an issuer may demand a rating because investors need the rating to fulfill regulatory or other requirements, even if neither party believes that the rating is a high quality assessment of creditworthiness. Regulatory reliance on ratings explains how CRAs can do well even if the quality of their analysis is poor. Reducing rating-dependent regulation might well improve rating quality by removing a source of demand for ratings that is not tied directly to quality[34].

2.7. American Business Ideals

An additional concern is that the U.S. firms' dominance of the CRA market forces rated businesses and governments worldwide to conform to U.S. business ideals in order to achieve high ratings. American CRAs argue that their evaluation approaches are free from influences based on the location and legal system of the rated entity. However, some governments are concerned that CRAs based in the U.S. make high ratings contingent upon the rated entities' willingness to incorporate American ideas of best business practices[35].

3. The Role of the Credit Rating Agencies in the Global Financial Crisis

The worldwide credit crisis of 2007-2009 was a series of interrelated events[36]. To name just a few of its aspects, the crisis encompassed seize-ups in markets for asset-backed commercial securities, the failure of an investment bank that had been a pillar of the U.S. financial system, an emergency grant of authority for massive government backing of government-sponsored enterprises that held nearly half of all U.S mortgages, a continuing series of failures among smaller regulated banks, and the near-total cessation of the engine of CDO (Collateralized Debt Obligation) issuance that had revved up so spectacularly over the preceding years. As of the middle of 2008, there were signs that the crisis was materially affecting the availability of credit for ordinary business and household uses in the United States and around the world, suggesting that the problems were not just limited to investment losses on novel instruments, but had spilled over into the "real" economy.

Although the crisis had a diverse set of interrelated causes, observers criticized CRAs sharply. Official bodies that reported on the crisis, including the U.S. President's Working Group on Financial Markets, the International Organization of Securities Commissions, the Financial Stability Forum, the staff of the Securities and Exchange Commission, and the European Commission, have been equally critical. The common thread in these accusations was that CRAs did a poor job of assessing the default risk of CDOs and other instruments based on subprime RMBS (Residential Mortgage-Backed Security), that high ratings on such securities had an inordinate effect on markets, and that when a large number of borrowers started to default on subprime mortgages in 2007, the low quality of the ratings was revealed and systemic consequences ensued. In particular, investors lost confidence in securitized products in general and were forced to sell securities at extremely low prices for liquidity reasons[37].

---

[34] Hunt, p. 26
[35] Bahena, p. 19
[36] Hunt, pp. 9-10
[37] Ibid., p. 12

More specifically, CDO and RMBS investors were dependent on CRA ratings to set prices, and when confidence in the rating process rightfully evaporated, so did any idea of how these products should be valued. Additionally, the CRAs continually adjusted their methodologies and downgraded debt right after an initial rating without explanation. Moreover, CRAs were critiqued for not downgrading CDOs and RMBSs quickly enough when new information came to light. In addition to that, each CRA had its own methodology for rating the securities. These methodologies were not internally consistent, as an AAA rating for an RMBS incorporated different, and ultimately incomparable, types of risk than the same rating for a plain bond. Furthermore, it was difficult to monitor the CRAs as modeling and performance data provided by the CRAs was not specific enough. Consequently, media coverage was particularly harsh and accused the CRAs of either gross breaches of independence or incompetence[38].

Critics emphasized the default rates on the underlying subprime mortgages, but that was not the only problem. CRAs were also questioned for fundamental defects in their methodologies for these products[39]. Moreover, ratings on some products that are not directly tied to subprime mortgages appeared to have performed poorly. For example, 2006 saw the introduction of the CPDO (constant proportion debt obligation), an instrument designed to meet fixed yield targets by increasing or decreasing leverage depending on market conditions. Nevertheless, in early 2008, Moody's downgraded almost half of the European CPDOs it had rated. At least some of CPDO downgrades apparently reflected a coding error in Moody's software that the company did not correct for several months. In addition, problems with CRAs' models were amplified by ratings-driven herding behavior among CDO arrangers; once an arranger devised a structure that received the desired ratings, others followed, so that any deficiencies in the CRA methodology were easily spread.

U.S. Treasury Secretary made it clear when presenting the policy statement of the President's Working Group on Financial markets in March 2008 that in the midst of market turbulence, officials, politicians and their advisers believe that CRAs play a major role in financial markets and that their work must be improved in terms of the specific challenges faced in rating complex finance instruments like structured securities, and by avoiding the reality or appearance of conflicts of interest[40]. These comments, and the energetic reaction of European financial regulators to the perceived culpability of the CRAs in the generation of the subprime crisis, point to the increasingly important function done by wholesale CRAs in global markets. The pressure of globalization led to the desire to tap the deep American financial markets and to a greater appetite for higher returns and thus risk. The result is that an essentially American approach to market organization and judgment has become the global norm in the developed world, and increasingly, in emerging markets as well[41].

Furthermore, as the sovereign debt crisis in the Eurozone began to unfold in the end of 2009, CRAs were again on the spotlight for another reason. Regardless of the financial package of EUR 110 billion that was made available to Greece by the Euro area Member States and the International Monetary Fund, Standard & Poor's, on April 26, 2010, downgraded Greek bonds down to a BB+ ("junk") status, the same level as those issued by far less stable countries. This

[38] Gudzowski, pp. 117-118
[39] Hunt, p. 12
[40] Sinclair, p. 4
[41] Ibid.

increased the interest rate investors charged the Greek government to borrow money on the open market. Following the downgrading of Greece and Portugal, the Euro collapsed more than 1.5%.

Consequently, EU Commission officials accused the markets of being out of step with reality and warned the CRAs that the EU would intervene by implementing new Regulations. In the words of a spokesperson of Commissioner Barnier of April 28, 2010: "[The Commission] would expect that when CRAs assess the Greek risk, they take due account of the fundamentals of the Greek economy and the support package prepared by the European Central Bank (ECB), the International Monetary Fund and the European Commission".

As the downgrades for Greece, Portugal, Spain and Ireland by the top three CRAs, all of them US-based, led to higher borrowing costs for the weaker Eurozone countries, senior European politicians, including Germany's Chancellor Angela Merkel, indicated their support for the creation of a European CRA. In a related move on May 3, 2010, the ECB decided to loosen the terms under which it lends money to Greek banks, indicating that it would in future accept Greek sovereign bonds as investment grade collateral, regardless of the "junk" status given them by S&P.

Evidently, credit ratings are increasingly central to the regulatory system of modern capitalism and therefore to governments everywhere. Ensuring the quality of ratings therefore seems vitally important to many observers. The increasingly volatile nature of markets has created a crisis in relations between the CRAs and governments, with the latter increasingly seeking to monitor CRAs' performance and stimulate reform in their procedures. The reforms are aiming at resolving what are perceived as the root causes for CRAs' failure: problems of poor economic models, conflicts of interest arising from the CRAs' dual role of consulting (in the process of structuring) and rating (the products created in such a process), and lack of effective regulation. Another factor is the market's excessive reliance on ratings, which has been reinforced by numerous laws and regulations that use ratings as a criterion for permissible investments or as a factor in required capital levels. Furthermore, due to the oligopolistic market structure, there is no effective competition between the three major CRAs. In other words, the market process has not been able to sanction the CRAs for their overly positive assessment of highly dubious assets[42]. Therefore, the legislation passed after the crisis of 2007-2008 attempts to incentivize competition as well as to facilitate civil liability claims against CRAs.

[42] Bofinger, p. 34

Table 1: Credit Rating Categories (notches)[43]

Rating group	Rating agency: Moody's	Rating agency: S&P, Fitch	Numerical value assigned*	Category definition**
Investment Grade	AAA	AAA	28	The obligor's capacity to meet its financial commitment on the obligation is extremel
	Aa	AA	24, 25, 26	The obligor's capacity to meet its financial commitment on the obligation is very stro
	A	A	21, 22, 23	Somewhat more susceptible to the adverse effects of changes in circumstances and eco conditions than obligations in higher – rated categories. However, the obligor's capa meet its financial commitment on the obligation is still strong.
	Baa	BBB	18, 19, 20	Exhibits adequate protection parameters. However, adverse economic conditions or ch circumstances are more likely to lead to a weakened capacity of the obligor to m financial commitment on the obligation.
Speculative Grade	Ba	BB	15, 16,17	Obligations rated 'BB', 'B', 'CCC', 'CC', and 'C' are regarded as having sign speculative characteristics. 'BB' indicates the least degree of speculation and 'C' the h While such obligations will likely have some quality and protective characteristics, the be outweighed by large uncertainties or major exposures to adverse conditions.
	B	B	12, 13, 14	
	Caa	CCC	9, 10, 11	
	Ca	CC	7	
	C	C	4	
Default	D	D	1	An obligation in payment default. The 'D' rating category is used when payments obligation are not made on the date due even if the applicable grace period has not ex unless Standard & Poor's believes that such payments will be made during such grace p The 'D' rating also will be used upon the filing of a bankruptcy petition or the takin similar action if payments on an obligation are jeopardized.

*Multiple numerical values for a single rating level represent ratings with a (+) qualifier, no qualifier, and a (–) qualifier, respectively.

**Source for ratings definitions is Standard & Poor's Ratings Definitions from March 17th, 2008.

[43] Duponcheele/Perraudin/Totouom-Tangho, p. 9

Table 2: Global CDO Issuance, in Billions of U.S. Dollars[44]

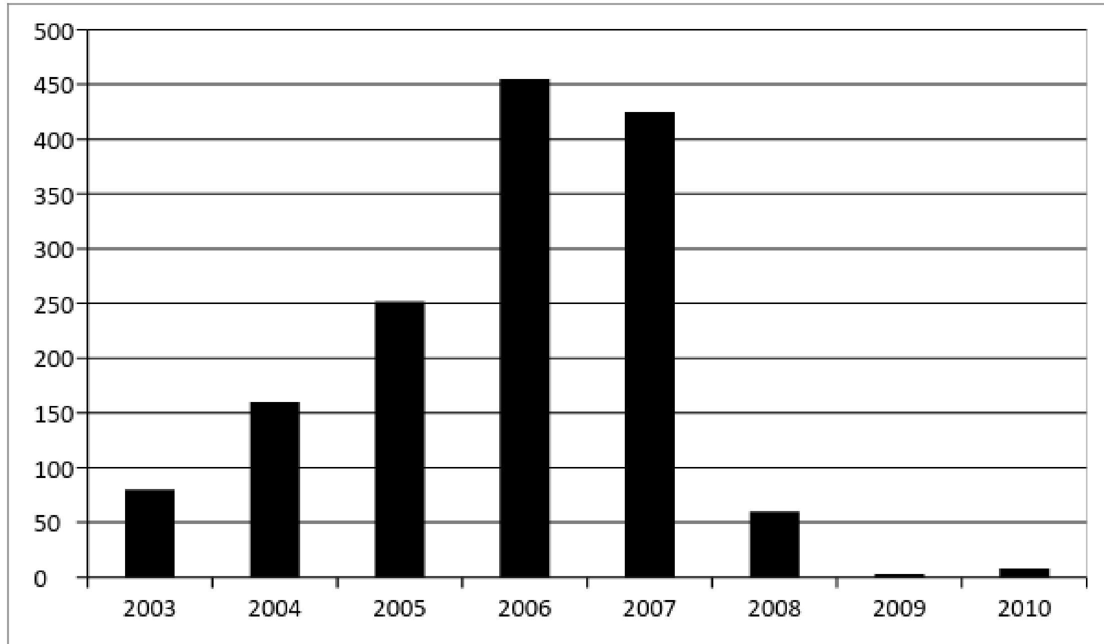
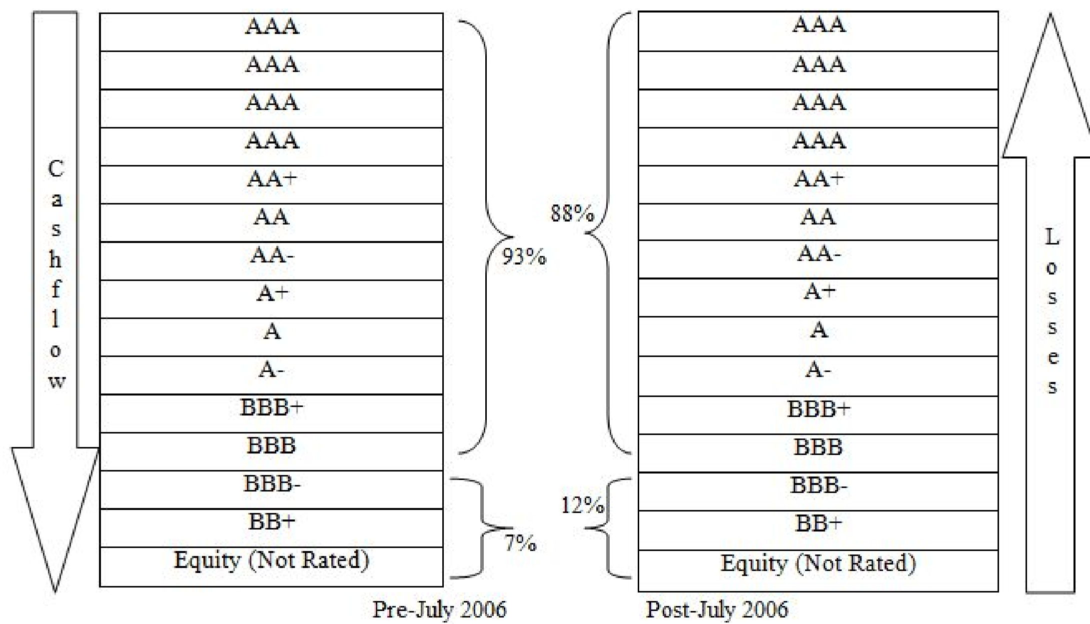


Table 3: Typical Structure of a Residential Mortgage Backed Security[45]



[44] Fordham Journal of Corporate and Financial Law, Vol. XVII, p. 718

[45] U.S. Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, Hearing on "Wall Street and the Financial Crisis: The Role of Credit Rating Agencies" of April, 23rd 2010, Exhibit #1m

Section B: Global Responses for the Regulation on Credit Rating Agencies

I. IOSCO Soft Law on Credit Rating Agencies

The International Organization of Securities Commissions (IOSCO) was the first international forum to investigate the role of CRAs in modern financial markets. In 2003, a time when most CRAs were subject to little or no regulation and oversight in most jurisdictions, IOSCO conducted a report[46] outlining the activities of CRAs and the regulatory concerns that arise from them. The major issue discussed in this report was the growing impact of credit ratings on investors and issuers, despite that they were not completely understood by them. This lack of understanding, along with the absence of regulatory framework on CRAs, raised questions on the integrity of the rating process, regarding the fair treatment of both investors and issuers and the confidentiality of the information provided to CRAs.

1. IOSCO CRA Four Principles (2003)

Consequently, the "IOSCO CRA Principles" were published in September 2003[47], as an attempt to shed light on the function of CRAs and the use of credit ratings. The Principles, a tool for both regulators and CRAs, addressed four key objectives to improve the rating process. First, CRAs should endeavor to issue opinions on the sole purpose of reducing the asymmetry of information among market participants, thus ensuring the quality and integrity of the rating process. Second, CRAs should avoid any relationship that may (appear to) compromise the independence and objectivity of the rating operations, especially those arising from conflicts of interest due to their ownership structure, their business activities apart from rating services and their employees' financial interests. Third, disclosure and transparency should be an objective in rating activities; and, finally, confidentiality of the information provided by the issuers should be guaranteed under the terms of confidentiality agreements.

2. IOSCO CRA Code (2004, 2008)

In order to provide a more detailed and specific guide on how the Principles could be implemented in practice, IOSCO published the first iteration of the IOSCO CRA Code[48] in December 2004. Based on the same four objectives of the Principles, the Code aimed mainly for the goals of investor protection, fairness, efficiency, and transparency in securities markets and the reduction of systemic risk. Furthermore, the Code was applicable to any CRA, regardless of its size, its business model and the market in which it operates.

The 2008 financial crisis led to the revision of the IOSCO CRA Code in May 2008, following a study[49] on the role of CRAs in the structured finance market by the IOSCO Chairman's Task Force on Credit Rating Agencies (*CRA Task Force*) – the predecessor of the Committee on Credit Ratings (*C6*). The 2008 Code came as an answer to questions regarding the quality of the information used in the ratings, the delay in reviewing existing ratings and make downgrades as appropriate, and the conflict of interest arising from CRAs advising issuers on how to design structured finance products. This revised 2008 Code introduced the "comply or

---

[46] IOSCO Technical Committee, Report on the Activities of Credit Rating Agencies (Sept. 2003)

[47] IOSCO Technical Committee, Statement of Principles Regarding the Activities of Credit Rating Agencies (Sept. 2003)

[48] IOSCO Technical Committee, Code of Conduct Fundamentals for Credit Rating Agencies (Dec. 2004)

[49] IOSCO Technical Committee, The Role of Credit Rating Agencies in Structured Finance Markets (May 2008)

explain” principle[50], rather than just suggesting best practices for CRAs. Although there are no adverse consequences for CRAs not complying with the provisions of the Code, any behavior that abstains from its specifications needs to be justified for. Thus, CRAs are encouraged to disclose their functioning framework, giving IOSCO a sort of indirect supervision over them (self-regulation system). The 2008 Code concentrates on three basic principles regarding the operations of CRAs: the quality and integrity of the credit rating process, CRA independence and avoidance of conflicts of interest, and CRA responsibilities to the investing public and rated entities. Several disclosure provisions were added with the 2008 revisions.

3. Revised IOSCO CRA Code (2014)

Given the emergence of CRA registration and oversight programs in the 2006-2010 timeframe, IOSCO published a report in 2010 on the implementation of CRA laws and regulations by regional and national authorities, in which it was stated that the IOSCO CRA Principles are building blocks on which CRA regulatory programs have been constructed. In July 2013, IOSCO recommended[51] the creation of supervisory colleges for certain globally active CRAs, as a forum for regulators to exchange information on these CRAs’ compliance. The colleges for S&P and Moody’s are chaired by the U.S. Securities and Exchange Commission, while the college for Fitch is chaired by the European Securities and Markets Authority. All three colleges held their inaugural meetings in November 2013.

As CRA regulation evolved dramatically, IOSCO published the “new IOSCO CRA Code” in 2014, to take into account the fact that CRAs are now supervised by regional and national authorities. The 2014 revisions are concentrated on three core objectives: firstly, to strengthen the Code in protecting the integrity of the rating process, managing conflicts of interest, providing transparency, and safeguarding non-public information; secondly, to add stricter measures on governance, training, and risk management; and lastly, to improve the clarity and update terminology. The new Code is intended to work in harmony with existing CRA laws and regulations, which take precedence over it[52], and to be the international standard for CRA self-governance.

To achieve the objective of quality of the credit rating process[53], CRAs should establish a credit rating methodology for each class of entity or obligation for which they issue ratings and apply it uniformly and consistently in assessing creditworthiness, so that ratings can be subjected to objective validation based on historical experience. Credit ratings should reflect all relevant information that the CRA has obtained from reliable sources, analyzed with the appropriate methodology by expert and experienced employees (analysts). On the other hand, a CRA should not issue ratings for entities or obligations for which it does not have adequate information, knowledge, and expertise. In addition, CRAs are advised to review past ratings on a timely basis, and maintain sufficiently detailed records to be able to update a given rating action. Furthermore, CRAs should avoid issuing ratings or reports that contain misrepresentations or are otherwise misleading. Finally, CRAs should devote sufficient resources to carry out high quality ratings. Especially when rating structured finance products,

---

[50] Mastromanolis, p. 76

[51] IOSCO Board, Supervisory Colleges for Credit Rating Agencies (July 2013)

[52] IOSCO CRA Code 2014, Preamble

[53] Ibid., Provisions 1.1 – 1.17

a CRA should assess whether it has the personnel and the information needed to conduct the rating.

Regarding the objective of integrity of the credit rating process[54], the Code prohibits any assurance from the CRA or its employees to the rated entities about the outcome of the rating process. CRAs are also prohibited from advising the rated entities or the obligors on anything that could impact the rating, such as corporate structure, business operations, and the design of structured finance products. Each CRA should establish a compliance function to ensure that it complies with the applicable laws and regulations of the jurisdiction(s) in which it operates.

Concerning the guarantees of independence and the avoidance of conflicts of interest[55] within the CRAs, the Code suggests that credit ratings should by no means be affected by factors irrelevant to the rating process, especially by whether there is a business relationship between the raters and the rated entity/obligor. To ensure the avoidance of conflicts of interest within the CRA, it is demanded that the credit rating business and the analysts are operationally, legally and physically separate from the rest of the CRA's businesses. Furthermore, the Code underlines the conflicts of interest that may arise from the issuer-pay model and declares that CRAs should establish the policies necessary to detect and manage these conflicts effectively, along with providing disclosures of these policies in the relevant ratings. In particular, disclosure is needed whenever a CRA is paid by the rated entity/obligor to issue a rating; or whenever it is paid by them for services unrelated to credit ratings; as well as when the CRA has a direct or indirect ownership interest in the rated entity. CRAs should also disclose whether they receive 10% of their annual revenue from a single client. In order to shield employee independence, the analysts should not participate in the negotiations on fees and payments, while CRA compensation policies must eliminate potential conflicts of interest and analysts' compensation must not be affected by the interest made of the distribution of trading instruments issued by rated entities/obligors. Obviously, analysts themselves should not hold or transact in such trading instruments.

The Code imposes certain responsibilities on CRAs to the investing public and rated entities/obligors. CRA responsibilities to the investors aim at providing transparency of credit rating disclosure and include several obligations[56] for CRAs, such as assisting the investing public to better understand the nature and limitations of credit ratings by disclosing sufficient information on the rating methodologies and clear definitions of the meaning of each category in the rating scales; distributing credit ratings to subscribers on a non-selective basis; and enabling investors to compare CRA performance by disclosing quantifiable, standardized historical information on issued ratings. Particularly when rating structured finance products, CRAs should disclose sufficient information about the loss and cash-flow analysis. On the other hand, CRA responsibilities to rated entities and obligors aim mainly to protect the confidential information[57] collected in the rating process. To achieve this protection, CRA employees are prohibited from using confidential and non-public information in any way irrelevant to the rating acts for which they were collected.

[54] Ibid., Provisions 1.18 – 1.24
[55] Ibid., Provisions 2.1 – 2.18
[56] Ibid., Provisions 3.1 – 3.18
[57] Ibid., Provisions 3.19 – 3.21

II. FSB Soft Law on Credit Rating Agencies

While IOSCO's approach sought to provide a set of best practices for regulating the overall function of CRAs – mainly the conflicts of interest that might result to market abuse, the Financial Stability Board (FSB) sought ways to minimize investors' excessive reliance on credit ratings. Indeed, given the role of CRAs in the 2007-2008 crisis, the mechanistic reliance of certain regulations on ratings was a major issue. In response to this, the FSB published in October 2010 a set of principles[58] focused on the goal of reducing both regulatory and market reliance on CRA ratings. The Principles were consequently endorsed by the G20 in November 2010.

1. FSB Principles for Reducing Reliance on CRA Ratings

According to the FSB, the rationale for reducing reliance on ratings in standards, laws and regulations[59] is that the hardwiring of CRA ratings in regulations ascribes a sort of official approval to them, which has negative effects on investors' own ability to assess creditworthiness and credit risks for themselves. Moreover, when the law requires large numbers of market participants to act in similar fashion, herding behavior is encouraged. This may cause "cliff effects" like in the 2008 crisis, when CRA rating downgrades amplified procyclicality and caused systemic disruptions. As a result, FSB calls for standard setters and authorities to replace the references to CRA ratings in laws and regulations by alternative standards of creditworthiness.

Additionally, in the scope of minimizing market reliance on ratings[60], the FSB suggests that major market participants, especially institutional investors, should make their own credit assessments. Combining the results of credit risk assessments carried out in the appropriate way by the firms with CRA ratings could be the key for successful risk management. In any case, investors are strongly discouraged from relying solely or mechanistically on CRA ratings, while regulators and supervisors must guarantee the integrity and quality of internal risk assessments. Furthermore, firms participating in financial markets are required to publicly disclose their credit risk assessment processes along with the extent to which these processes are based on external ratings. The FSB recognizes the importance of CRA ratings when they are appropriately used in that they can be a helpful tool for minor and less sophisticated firms in understanding economies of scale. Thus, it does not seek to exclude external ratings from risk management approaches completely, but to include them as part of internal risk assessment. This way, investors are expected to take more responsibility in ensuring that their credit exposures are based on sound assumptions.

Elaborating the abovementioned principles, the FSB provides several guidelines on how these could be best applied in particular areas of financial market activity[61], such as central bank operations, banking prudential supervision, policies of investment managers and institutional investors, private sector margin agreements, and disclosures by issuers of securities. Central banks, for instance, are advised to decide on the financial instruments eligible as collateral and as outright purchases based on their own credit judgments[62]. Supervisors, on the other hand, should demand that the banks in their jurisdiction are capable of assessing internally the

---

[58] Financial Stability Board, Principles for Reducing Reliance on CRA Ratings (October 27th, 2010)
[59] Ibid., Principle I
[60] Ibid., Principle II
[61] Ibid., Principle III
[62] Ibid., Principle III.1

creditworthiness of the financial instruments to which they are exposed, while the banks should be able to satisfy this demand[63]. Taking into consideration the resources needed for an efficient internal credit assessment unit, an exception is made for smaller banks, which may use CRA ratings for some of their assets, but still need to publicly disclose in detail to what extent and for which investments they rely on external ratings[64].

Moreover, the FSB Principles emphasize the responsibilities of investment managers and institutional investors when assessing the creditworthiness of assets and clarify that CRA ratings are not a substitute for due diligence in investment policies decisions[65]. Independent credit judgments should be favored over CRA ratings, which can, nevertheless, be used as broad benchmarks in internal limits and credit policies. Investment managers and institutional investors should disclose whether CRA ratings are used in risk assessment processes and to which extent[66].

Also, the FSB Principles make an attempt at restricting the use of CRA ratings as automatic triggers for collateral calls in private sector margin agreements on derivatives and securities financing transactions[67]. Meanwhile, supervisors should take measures that such CRA rating triggers are not used as factors in reducing regulatory capital requirements[68]. Finally, to bridge the informational gap between issuers and investors, which determines the role of CRAs in modern financial markets, the FSB suggests that issuers of securities disclose comprehensive, timely information in order for the investing public to make their own independent investment judgments and credit risk assessments of the securities traded[69].

2. FSB Roadmap and Thematic Review

However, due to the rather disappointing conclusions of the 2012 FSB report to the G20 Finance Ministers and Central Bank Governors on the progress of implementing the Principles by translating them into more specific policy actions in each jurisdiction, along with the G20 Leaders call[70] for accelerated progress on the matter, a roadmap[71] was published in 2012. The Roadmap provides detailed steps with potential timelines for international standard setters and national/regional regulators on how to efficiently incentivize market participants to rely less on CRA ratings. It consists of two tracks which are meant to progress in parallel; the first aimed at reducing mechanistic reliance on external ratings by eliminating the references of ratings in standards, laws and regulations, and the other aimed at strengthening internal credit risk assessment in financial institutions as a replacement for CRA ratings, by requiring the disclosure of the relevant approaches adopted.

---

[63] Ibid., Principle III.2
[64] Ibid., Principles III.2.a and III.2.b
[65] Ibid, Principle III.3.a
[66] Ibid, Principle III.3.b
[67] Ibid, Principle III.4
[68] Ibid, Principle III.4.a
[69] Ibid, Principle III.5
[70] G20 Leaders Declaration, Los Cabos, Mexico, June 18th-19th, 2012
[71] Roadmap and workshop for reducing reliance on CRA ratings – FSB report to G20 Finance Ministers and Central Bank Governors, 5 November 2012

In order to support the implementation of the Roadmap, the FSB undertook a thematic peer review[72] to assist national and regional authorities in fulfilling their commitments under the Roadmap. The findings of this review were quite satisfactory, as legislators and regulators in both the U.S. and the EU had already undertaken significant actions to remove the hardwiring of credit ratings from legislation. Furthermore, the review highlighted that coordination across national agencies and guidance from international standard setters are the keys to successful implementation of the Principles within the Roadmap's timeframe.

III. American Responses: Regulation of the Credit Rating Agencies in the U.S.

1. Regulation Background (1909 - 1970)

Although CRAs emerged in the 1900s, regulators had shown no interest in them until the 1930s. For many decades CRAs were generally recognized as reliable experts in the field of complex finance ratings and their neutrality was taken for granted, mostly on the grounds of the reputational theory arguments. Consequently, the quality and objectivity of the ratings was not an issue for legislators to worry about.

Given that CRAs emerged in the U.S., it comes as no surprise that they were first regulated under the American legislation. Shortly after the Great Depression, U.S. regulators naturally turned to CRAs – primarily Moody's and Standard & Poor's – for measures of bond quality in banking and insurance guidelines[73]. It was then that regulation became entangled with credit ratings for the first time, in the scope of preserving the systematic stability of the banking system and protecting liability holders[74]. Obviously, the rationale was not to regulate CRAs directly, but rather to use credit ratings as a means to oversee the financial markets.

Federal Reserve examiners proposed a system for weighting the value of a bank's portfolio based on ratings. Bank and insurance regulators expressed the safety or desirability of portfolios in letter ratings, and used such ratings in bank capital requirements and bank and insurance company investment guidelines. States relied on rating agencies to determine which bonds were "legal" for insurance companies to hold. The Comptroller of the Currency made similar determinations for federally chartered banks[75].

More precisely, the first set of regulations involving CRAs went into effect during the years after the banking crisis of March 1931. Following the onset of the Great Depression, banks were in need of liquidity and so they dumped their lower grade bonds on the market, which contributed to the overall decline in bond prices. This lower valuation of bonds reduced the market value of banks' bond portfolios overall and contributed to bank failures, demonstrating that bond values, rather than simply defaults, also mattered to bank survival. Consequently, the Office of the Comptroller of the Currency (OCC) – with the hopes of preventing future bank failures – set out to regulate banks' capital reserves by setting minimum requirements to ensure banks did not become overleveraged[76]. To ensure compliance with the new regulations, the OCC looked for an outside group with expertise in evaluating bonds to

[72] Financial Stability Board, Thematic Review of the FSB Principles for Reducing Reliance on CRA Ratings (final), 12 May 2014

[73] Darbellay/Partnoy, p. 3

[74] Dittrich, p. 16

[75] Partnoy (2009), p. 4

[76] McClintock/Calabria, p. 7

determine how much risk, and thereby how much value, was associated with banks' assets. CRA ratings helped the OCC conduct a valuation of national bank bond portfolios.

Therefore, in 1936, the OCC and the Federal Reserve directed that banks not hold bonds rated below BBB by at least two CRAs and, inevitably, introduced CRAs into the financial regulatory framework. Banks were now required to obtain credit ratings for their assets, to ensure they met federal capital reserve requirements, and they were also provided additional incentives for holding bonds rated highly by CRAs[77]. As a result, both banks and issuers had to keep into account the ratings issued by agencies, which started then to influence the ability of securities to be sold in the market.

Despite the very innovative significance of the disposition, no explicit reference was made to the criteria used to select the rating agencies to be considered. The regulation only referred to "recognized rating manuals", implicitly pointing those issued by the current major agencies (S&P, Moody's, and Fitch)[78]. This approach of adopting credit ratings for regulatory purposes attributed a sort of *regulatory license* power to CRAs[79], which initiated the blossom of the credit rating industry. From there on until the 1970s, there were no noteworthy changes in the legislation dealing with CRAs, mostly as a result of a healthy economy and few defaults[80].

2. Credit Rating Agencies as Nationally Recognized Statistical Rating Organizations

Amid the credit crises of the early 1970s – caused due to inadequate access to liquid capital – the Securities and Exchange Commission (SEC) adopted new banking regulation rules. So, the Net Capital Rule for broker-dealers (Rule 15c3-1) was amended in 1975, to ensure *that registered broker-dealers have adequate liquid assets to meet their obligations to their investors and creditors*[81]. By its Rule 15c3-1 the SEC proposed to set some minimal asset requirements for securities broker-dealers. Such requirements were linked to the quality of bonds in their portfolio, using ratings provided by the CRAs as the essential parameter for the evaluation. In that occasion, the SEC made a pivotal distinction in identifying the class of CRAs that were appointed to issue such evaluations. They were designated as the Nationally Recognized Statistical Rating Organizations (NRSROs) – the only CRAs qualified to issue appropriate ratings to rank minimal assets requirements[82]. The SEC instituted the NRSRO designation to ensure that bank issuers would not simply find CRAs whose only purpose was to deliver high ratings on demand.

Only a select few NRSRO designations were granted; the three major agencies then and currently on the market (Moody's, S&P, and Fitch) were immediately recognized as such, mainly by virtue of their previous record of accurate ratings. The NRSRO concept involved minimal, informal oversight, since it relied on market acceptance rather than regulatory standards[83]. Besides, obtaining a designation was not necessary for CRAs to operate. Nevertheless, NRSROs were privileged against other CRAs, as particular investors (including

[77] Ibid., p. 8
[78] Conte/Parmeggiani, p. 3
[79] Mastromanolis, p. 112
[80] Maris, p. 3
[81] McClintock/Calabria, pp. 7-9
[82] Conte/Parmeggiani, p. 4
[83] Katz/Salinas/Stephanou, p. 2

pension funds and insurance companies) were legally mandated to purchase investments highly rated by NRSROs.

This shift in regulatory approach corresponded to a change in the economics of the credit rating industry. On the one hand, as investors were incentivized to purchase investments highly rated by NRSROs to obtain regulatory benefits, the demand specifically for such ratings increased significantly[84]. On the other hand, bond issuers could not access certain markets without high ratings, because they did not have a *license* from the NRSROs to comply with NRSRO-dependent regulations[85]. As a result, profits for NRSROs increased, due to the expanding demand for their ratings. These regulatory licenses entitled credit ratings to gain and generate reputational capital among market participants. This sort of reputational capital, usually based on trust and credibility, is a fundamental component of rating business model because it makes for confidence and investor protection[86]. At the same time, CRAs abandoned their historical practice of charging investors for subscriptions and began charging issuers for ratings instead. As additional regulations came to depend more on NRSRO ratings, those ratings became more important and more valuable[87].

The use of ratings in public regulation demonstrated that the rating industry was more than a financial phenomenon. CRAs' ratings, NRSROs' in particular, were at last valuable not only because they contained valuable information, but because they granted issuers regulatory licenses[88]. A good rating would entitle the issuer (and the investors in a particular issue) to certain advantages related to regulation. The progressively wider use of ratings for regulatory purposes allowed a small group of CRAs to share a quasi-monopoly rent from providing regulatory dispensations. Consequently, as the main rationale of ratings shifted from credit evaluations to regulatory dispensations, the incentives for agencies to focus narrowly on accurately assessing credit quality diminished[89].

Even so, the regulation was very vague as to criteria and procedures adopted to grant the NRSRO recognition, which was allowed by sending a "no-action" letter to the CRAs that applied for the NRSRO status. Such a letter only stated that the Division of Market Regulation of the SEC would have taken no action against those broker-dealers that would use the ratings issued by such approved agencies. The absence of a detailed set of rules about necessary requirements to obtain such qualification made the procedure very discretional and poorly transparent[90]. The basic criteria adopted by the SEC to evaluate the applications for NRSRO status generally included the nationwide reputation of the CRA, its organizational structure, its financial situation, its size, the expertise of its personnel, the degree of independence from the rated companies, the rating procedures and the protection of confidential information.

In order to make the rules in force more accurate, in 1997 the SEC proposed a formal codification of the evaluation parameters for NRSROs, which resulted to be the same ones

[84] McClintock/Calabria, pp. 7-9
[85] Darbellay/Partnoy, p. 4
[86] Miglionico, pp. 30-31
[87] Partnoy (2009), p. 64
[88] Ibid., pp. 81-83
[89] Duponcheele/Perraudin/Totouom-Tangho, pp. 3-4
[90] Conte/Parmeggiani, p. 4

that informally were already taken into consideration. Although four CRAs were then recognized as NRSROs, they were eventually acquired by the three main NRSROs, leading to a de facto state-sanctioned oligopoly[91].

CRAs came under fire in the early 21st century with the implosion of Enron, WorldCom, Parmalat and California's Orange County, most of whose bonds were given investment-grade ratings by the dominant CRAs with NRSRO designations only within a few days or months before they filed for bankruptcy protection[92]. In 2005 in particular, the SEC decided to re-define the qualifying parameters of the NRSROs, although without modifying in substance the requirements for recognition, which were linked to the importance the agency had in the market. The well-established pivotal importance of such a requisite has certainly contributed to the fact that in a period of over thirty years, only six NRSROs have been recognized[93].

3. Credit Rating Agency Reform Act (2006)

Following the above mentioned financial scandals in the early 2000s, the function of CRAs, especially NRSROs, was in the spotlight. Both SEC's reports and hearings before the Senate and the House of Representatives on the scandals noticed the national importance of CRAs, along with the need to foster transparency and competition in the credit rating industry[94]. Therefore, U.S. legislators introduced a new system of NRSRO qualification, which organized the vague criteria for NRSRO designation and reformed the questionable procedure that was followed by the SEC until then. The Credit Rating Agency Reform Act (CRARA), which was enacted in 2006, proposed a standardized procedure for CRAs wishing to be registered as NRSROs under the SEC. This procedure included certain criteria which NRSRO-status-applicants should fulfill.

More specifically, CRAs applying for NRSRO registration were required[95] to have been in the business of credit ratings for at least the three consecutive years prior to the application date. This condition was set as a means to assess each applicant's expertise and the trust which the market participants – especially institutional investors – placed on its issued ratings. Additionally, any CRA aspiring to be registered as NRSRO should file a relevant application [96] for the SEC to approve. The application should include, among other things, information on credit ratings performance measurement statistics; the procedures and methodologies used in assessing credit ratings; policies adopted to prevent the misuse of confidential information; the applicant's organizational structure; whether it has in effect a code of ethics (on a comply-or-explain basis); and any conflict of interest related to the issuance of credit ratings.

On the other hand, the CRARA also recognized[97] the existence and function of CRAs other than NRSROs, although they were not regulated under it. As a result, non-NRSRO CRA issued credit ratings could not be used by investors for the purposes of regulatory licenses. This distinction led to a two-tier system of CRAs under U.S. regulation. In fact, the major

[91] Cinquegrana, pp. 4-5
[92] McClintock/Calabria, pp. 7-9
[93] Conte/Parmeggiani, p. 5
[94] Credit Rating Agency Reform Act of 2006 (CRARA), Section 2
[95] Ibid., Section 3 (a) (62)
[96] Ibid., Section 4 (a), which amended the Securities Exchange Act of 1933 by inserting Section 15E
[97] Ibid., Section 3 (a) (61)

CRAs who shared the largest portion of the global credit rating market were recognized as NRSROs under the CRARA criteria along with few other CRAs.

Moreover, under the CRARA provisions the SEC was vested with the exclusive authority to enforce the regulatory provisions with respect to NRSROs[98]. Consequently, the SEC could censure, place limitations on the activities, functions, or operations of, suspend, or even revoke the registration of any NRSRO if: (a) it failed to submit to the SEC the reports required by the law, or (b) it failed to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity, and (c) these actions were necessary for the protection of investors and in the public interest[99]. In other words, the SEC was formally appointed as the supervisor of NRSROs – with censure powers over the ratings they issue and denial, suspension and revocation powers over their registration status.

Additionally, the public interest approach of credit ratings is reflected in the CRARA. Because of the evolution and expansion of finance markets, ratings resulted in affecting the general public, instead of institutional investors and bond issuers only. This was recognized under the CRARA, which stated that ratings serve the public interest by intermediating in information transmissions and by enhancing market transparency. The notion that ratings are of public concern justified the regulatory intervention in CRA and NRSRO functions[100]. It was ordained that CRAs and NRSROs were not commercial credit reporting companies[101] and that oversight of them would serve the irrefutable interest of investor protection[102].

Despite acknowledging the significant role of credit ratings, legislators were still reluctant at the time to impose a stricter regulatory framework on CRAs and NRSROs – mainly because they thought that guaranteeing minimal requirements for NRSRO registration would be a sufficient measure to shield the bona fide use of ratings. Besides, as CRA opinions were handled as of public interest, it was suggested that they should be subjected to the necessary restrictions only[103].

Although two of the CRARA main goals were to intensify transparency in the credit rating industry and to provide the minimum standards that a CRA should satisfy to acquire NRSRO designation, it seems to have had the exact opposite results. On the one hand, only criteria for NRSRO registration were provided, while the ongoing function of registered NRSROs was poorly regulated. Obviously, the fact that a CRA might meet the registration criteria at the application time does not imply that it will continue to do so in the future. Apart from reports submitted by the agencies themselves, the SEC had no power to test the eligibility status of registered NRSROs. So, the regulators' will to safeguard the quality and trustworthiness of NRSROs was not implemented on an ongoing basis. On the other hand, given that investors' and bond issuers' trust on the past ratings of a certain CRA was included in the NRSRO registration criteria, one would expect that the regulation would also call for transparency in the transactions between CRAs and their clients (mainly bond issuers since the 1970s). Unfortunately, such disclosure provisions were not part of the CRARA.

---

[98] Securities Exchange Act of 1933, Section 15E (c)
[99] Ibid., Section 15E (d)
[100] Mastromanolis, p. 114
[101] Credit Rating Agency Reform Act of 2006 (CRARA), Section 3 (a) (61)
[102] Ibid., Section 2 (4)
[103] Mastromanolis, p. 114

To conclude with, CRARA was the first attempt to regulate CRAs and NRSROs per se. All legislation relevant to CRAs that was passed before 2006 was focused on regulating the *legal* use of credit ratings as regulatory licenses for bond issuers wishing to enter the finance markets. CRAs had been granted a de facto gatekeeper role and their integrity was never questioned, as the reputational theory prevailed. In the CRARA regulators seem to make a significant turn, by sensing for the first time that not only the use of ratings by other market participants, but CRAs' functions and activities must be as well examined. One could argue that assessing the integrity and the overall status of the issuer is a prerequisite for using the credit ratings issued in the optimal way. However, the three major CRAs had argued persuasively that the risk of a possible reputational damage was sufficient to keep them in line. This notion is reflected in the CRARA as well, though legislators appear only partially convinced by it. As a result, CRARA imposes a minimal regulatory framework for NRSRO registration and function. The inadequacy of the CRARA regulatory system was realized only after the recent financial crisis.

4. The American Response to the Crisis: Dodd-Frank Act (2010)

Since the early 2000s, CRAs had begun rating greater numbers of issuers and more complex finance instruments, while the resources expended per rating declined. Specifically, as the credit ratings expanded to cover large numbers of structured finance products, including tranches of various collateralized debt obligations (CDOs), some NRSROs did not update rating models and methodologies accordingly to keep up with financial innovation[104]. As a senior analytical manager at one of the big three agencies put it in a February 2007 email[105], "[w]e do not have the resources to support what we are doing now".

As soon as the subprime mortgage crisis began to unfold in December 2007, flawed credit ratings came under severe criticism over the huge losses caused to the U.S. economy. Although each financial crisis seems to have a cycle of complaints about failures among the CRAs, the consequences of the second wave of ratings failures in 2007-2008 were much more severe and the root causes were much more complex[106]. In June 2008, the SEC reported[107] that its examination of the three dominant CRAs had uncovered serious deficiencies in their ratings and rating processes, which led to legislators holding hearings criticizing the CRAs, and regulators recommending reforms. Consequently, a wholesale reform at CRA regulation was one of the main objectives of the financial reform legislation for the first time[108].

Congress confronted the difficult task of providing regulation to a complex system which very few individuals really understood[109], and which possessed the power to cast the U.S. economy into severe recession or even depression. The result of Congress's efforts became law on July 21, 2010 – when President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). In the core of the Act lies the restitution of trust between

---

[104] Darbellay/Partnoy, p. 4

[105] U.S. Senate, April 23, 2010 Hearing on Wall Street and the Financial Crisis: The Role of CRAs, Document no. 86

[106] McNamara, p. 720

[107] Securities and Exchange Commission, Summary Report of Issues Identified in the Commission Staff's Examination of Select CRAs, (2008 SEC Summary Report)

[108] McClintock/Calabria, p. 29

[109] McNamara, p. 722

investors and issuers in the U.S. capital markets[110], which was damaged because of informational failures, lack of transparency and multiple conflicts of interests in finance trading. Moreover, the Act seeks to reduce the risks of shadow banking and the damages of bank failures.

More specifically, the Dodd-Frank Act establishes the new regulatory framework of CRAs and NRSROs in Title IX, Subtitle C (Sections 931-939): *Improvements to the Regulation of Credit Rating Agencies*. The regulatory system suggested is much broader than that of the CRARA and aims to cure all those market failures which caused the 2007-2008 crisis. A prevalent argument reflected in the Dodd-Frank Act is that the gatekeeper role of NRSROs justifies a similar level of accountability and oversight as the role played by other gatekeepers, such as securities analysts and auditors[111]. Therefore, the Act addresses, among other issues, both legal liability for NRSROs and the regulatory overreliance on credit ratings.

Two sets of regulatory incentives cover oversight and accountability[112]. Firstly, with respect to oversight, the Act provides for a new regulatory body with the power to regulate CRA practices, including disclosures, conflicts of interest, and rating methodologies. Additionally, due to the persistent demand for transparency, the Act amends Section 15E of the Securities Exchange Act by imposing new reporting, disclosure, and examination requirements[113]. Secondly, with respect to accountability, the Dodd-Frank Act includes provisions to make CRAs more accountable by treating them the same as bankers, accountants, securities analysts and lawyers with respect to Section 11 of the Securities Act[114]. Finally, the legislation calls for the removal of many rating-based regulations, and thus reduces overreliance on credit ratings. However, it does not completely eliminate regulatory uses of credit ratings[115].

In summary, the mandates of the Dodd-Frank Act concerning CRAs fall into three general categories: enhanced supervision and transparency (4.1), which can be further analyzed as management of conflicts of interest (4.1.1) and extensive disclosure (4.1.2); increased exposure to litigation risk (4.2); and reduced reliance on credit ratings (4.3).

4.1. Supervision and Transparency

According to the Congress's findings, necessary improvements would require both a change in regulatory structure and new regulatory powers. The Dodd-Frank Act reflects an approach towards a more uniform regulatory structure, in order to consolidate ratings regulation within one umbrella organization with additional responsibilities and new powers[116]. As a result, the Act expands[117] the SEC's regulatory authority with regard to NRSROs to set a new structure with increased supervisory powers. Furthermore, a new authority (the Office of Credit Ratings) within the SEC was created and appointed as the empowered overseer of the rating industry[118]. The Office of Credit Ratings is to police the rules regulating NRSROs and file

---

[110] Mastromanolis, p. 115
[111] Dodd-Frank Act, Section 931(3)
[112] Darbellay/Partnoy, p. 2
[113] Miglionico, pp. 82-83
[114] Darbellay/Partnoy, p. 2
[115] Miglionico, p. 83
[116] Darbellay/Partnoy, p. 7
[117] As compared to CRARA, that prohibited the SEC from regulating the substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings.
[118] Dodd-Frank Act, Section 932(a)(8)

annual reports to the public. These new supervisory rules result from the realization that NRSROs are fundamentally commercial, thereby implying that they have to be subject to stricter regulatory standards similar to other gatekeepers, since the systemic importance of ratings is being acknowledged[119].

Moreover, the Dodd-Frank Act gives regulators increased powers to set standards in the rating industry, mainly emphasizing on transparency. As a result, NRSROs are required to disclose a significant amount of information; they have to file reports with the SEC and these reports must be made available to the public as well. Section 932(a)(8) also provides that the SEC must implement rules requiring that NRSROs disclose their rating performance, with the intent of allowing users to evaluate the accuracy of ratings and compare the performance of ratings by different NRSROs[120].

The Dodd-Frank Act establishes new regulation of rating procedures and methodologies: NRSROs must create a form to accompany the publication of each credit rating that discloses information on rating methodologies and on the assumptions underlying the ratings[121]. Additionally, Section 938(a)(2-3) requires NRSROs to define the meanings of the rating symbols. The same symbols across different categories of financial instruments can be used only if they are applied consistently, so that a triple-A rating in structured finance should have the same meaning as a triple-A rating in corporate or sovereign debt.

There are new governance rules, too; NRSROs have to establish effective internal control structures to govern the implementation of the policies, procedures and methodologies for determining ratings[122]. Section 931(4) of the Dodd-Frank Act acknowledges the need to address and resolve conflicts of interests in the rating industry. On the one hand, under Section 932(a)(8), the Office of Credit Ratings is charged to ensure that NRSRO ratings are not unduly influenced by such conflicts[123]. On the other hand, NRSROs are required to monitor conflicts of interest internally as well[124]. Moreover, the qualifications of analysts are now regulated under Section 936, which includes requirements for standards on credit rating analysts. Regulators shall test whether analysts hired by NRSROs have sufficient skills through a new training process, which will be supervised by the government.

Finally, the Act gives the SEC the ability to bar NRSROs in case of serious defaulted credit ratings; more specifically, under Section 932(a)(3)(I), the SEC has the ability to revoke the registration of a NRSRO with respect to a particular class of securities[125].

4.1.1 Conflicts of Interest

As stated at the beginning of Dodd-Frank Act's Subtitle C[126], conflicts of interest are believed to be central to the problems of NRSROs; so, it is the Act's primary focus to insulate NRSROs from such conflicts. Subtitle C ends with a declaration that the SEC ought to do

[119] Ibid., Section 931

[120] Section 15E of the Securities Exchange Act of 1933 (q)(1) as amended by the Dodd-Frank Act and codified as 15 U.S.C. 78o-7 (q)(1)

[121] 15 U.S.C. 78o-7(s)(1)

[122] 15 U.S.C. 78o-7(c)(3)(A)

[123] 15 U.S.C. 78o-7(p)(1)(A)(iii)

[124] 15 U.S.C. 78o-7(t)(3)(B)

[125] 15 U.S.C. 78o-7(d)(2)(A)

[126] Dodd-Frank Act, Section 931(4)

more to control the conflicts[127]. Therefore, the legislation includes an attempt to police conflicts of interest at the NRSROs, as part of eliminating the causes of flawed ratings. The most important of the conflicts provisions are contained in Section 932 (*Enhanced Regulation, Accountability, and Transparency of NRSROs)*.

First, Section 932(a)(4) mandates the separation of ratings activities from sales and marketing activities undertaken by a NRSRO, while the SEC is required to issue rules to prevent the sales and marketing considerations of a NRSRO from influencing the product of credit ratings issued by it. These rules aim at separating the business services provided by a gatekeeper from its marketing efforts as an independent organization in a free-market environment, and are a response to a number of instances of marketing concerns, as detailed in the SEC's 2008 Summary Report[128].

In addition to sales considerations influencing the ratings process, the Dodd-Frank Act also addresses conflicts of interest arising from CRA employees wishing to work in better positions with issuers and other financial markets employers. Section 932(a)(4) sets a look-back requirement, which mandates that in the event of any employee of a NRSRO leaving for employment with an issuer of a money market instrument subject to credit rating issued by this NRSRO, the NRSRO must review whether any conflict of interest influenced the above mentioned rating, and revise such rating accordingly if necessary. Furthermore, Section 932 adds Section 15E(h) to the Securities Exchange Act Section 5, requiring NRSROs to report to the SEC on certain employees obtaining employment with any issuer of a money market instrument for whom the NRSRO has issued a credit rating in the past year. This new reporting requirement includes all employees within the past five years who directly participated in determining credit ratings for their new employers, those who supervised employees who did so, and all senior officers. These employment-related provisions respond to the reports of numerous rating analysts leaving for better positions with other financial institutions, and the pressures and temptations facing those working for the NRSROs[129]. The look-back provision of new Section 15E(h)(4) also mandates SEC review of NRSRO relevant compliance, as well as annual reviews of the codes of ethics and conflicts of interest policies of each NRSRO.

Amongst its other duties, the Office of Credit Ratings within the SEC has the obligation to actively monitor conflicts of interest, the management of which is required for the annual review of each NRSRO[130]. The SEC is also charged with issuing new rules mandating disclosure concerning the transparency of ratings performance[131], including a rule requiring that the NRSROs attach an attestation with any credit rating they issue affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the instruments being rated, and that such rating was an independent evaluation of the risks and merits of the instrument[132]. Finally, new 15 U.S.C. Section (s)

[127] Ibid., Section 939H
[128] McNamara, p. 723
[129] Ibid, p. 724
[130] Dodd-Frank Act, Section 932(a)(8) (to be codified at 15 U.S.C. 78o-7(p)(3)(B)(ii))
[131] Ibid., Section 932(a)(8) (to be codified at 15 U.S.C. 78o-7(q)(1))
[132] Ibid., Section 932(a)(8) (to be codified at 15 U.S.C. 78o-7(q)(2)(F))

requires each NRSRO to disclose information relating to conflicts of interest of the particular agency on a new form accompanying each credit rating[133].

All the above provisions relate to disclosure of information concerning conflicts of interest, both to users of credit ratings and to the SEC. The Dodd-Frank Act also includes mandates concerning corporate governance at the NRSROs, in an attempt to instill independence at the agency level. New Section (t) of 15 U.S.C. 78o-7 (*Corporate Governance, Organization, and Management of Conflicts of Interest*) requires that at least one half of the board of directors of an NRSRO be independent, and that a user of ratings is included among the independent board members[134]. In addition, the compensation of board members should not be linked to the business performance of the NRSRO, while the establishment, maintenance and enforcement of policies and procedures to address, manage, and disclose any conflicts of interest are among the duties of the board[135].

Section 932 contains the new disclosure and governance provisions which are meant to police conflicts of interest at the CRAs. These provisions employ a common strategy of U.S. securities law, by mandating disclosure in the belief that investors can make their own decisions based on the information revealed to them[136]. Much like the Sarbanes-Oxley Act did with other gatekeepers such as auditors, the Dodd-Frank Act promotes an active interference in the internal corporate governance of the CRAs, by increasing the number of independent board members.

Three more provisions concerning conflicts of interest should be noted: Sections 939C, 939D and 939F of the Dodd-Frank Act all mandate studies of possible alternative ways of providing credit information to the markets which had been discussed and proposed in the run-up to the passage of the Act[137]. Section 939C requires the SEC to study the independence of the CRAs and how the lack of it affects their performance. Section 939D requires the Government Accounting Office to study alternative means of compensating the CRAs for their services; in other words, to search for alternatives to the issuer-pays business model, the most evident conflict of interest in the current ratings system. Finally, Section 939F requires the SEC to study the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns ratings to the individual NRSROs. This is the descendant of the rejected *Franken Amendment*, which would have established such a ratings assignment system[138].

In conclusion, reducing the effects of conflicts of interest was a central goal of the drafters of the Dodd-Frank Act, with the intend to help insulate the CRAs from improper responses to technical problems that arise in complex ratings systems, and incentivize the production of objective ratings in the first place.

4.1.2 Disclosure

---

133 Ibid., Section 932(a)(8) (to be codified at 15 U.S.C. 78o-7(s))
134 Ibid., Section 932(a)(8) (to be codified at 15 U.S.C. 78o-7(t))
135 Ibid., Section 932(a)(8) (to be codified at 15 U.S.C. 78o-7(t))
136 McNamara, p.726
137 Ibid., p. 727
138 Ibid.

Disclosure is a fundamental principle in U.S. securities regulation[139], based on the notion that requiring issuers to disclose crucial information about the security that investors are considering to purchase is essential to the efficient functioning of the markets. As long as issuers provide the required information, and that information is truthful and complete, the responsibility of evaluating it shifts to the potential investor. Consequently, the Dodd-Frank Act contains numerous disclosure requirements concerning the ratings process.

Firstly, subsection (p) of 15E of the Securities Exchange Act requires that the Office of Credit Ratings conduct yearly examinations of each NRSRO. These examinations cover a wide field of CRAs operations, including whether business is conducted according to the stated policies, procedures and ratings methodologies; implementation of the ethics policy; corporate governance; and internal supervisory controls. Additionally, the Office of Credit Ratings has to issue an annual report to the public summarizing the findings of the examinations conducted, the responses from the NRSROs on the identified deficiencies, and whether the deficiencies identified in previous examinations have been addressed[140].

Secondly, rule 15E(q) demands each NRSRO to issue detailed public disclosure regarding each obligor, security and money market instrument rated, as well as all subsequent changes to such ratings. These disclosures should be comparable across NRSROs and clear enough to be used by investors with different degrees of sophistication. They should also include performance information from a variety of types of credit ratings, including ratings that have been withdrawn. They have to be published on the NRSRO's website, too. Furthermore, an attestation affirming that the credit rating was not influenced by other business activities of the NRSRO, that it was based solely on the merits of the instrument rated, and that it was an independent evaluation of such instrument, needs to be included in each rating.

Thirdly, Section 15E(r) commands the SEC to prescribe rules concerning the methodologies NRSROs use to rate securities. However, the Exchange Act Section 15E(c)(2) remains in force, and the SEC does not have the power to dictate the *substance of credit ratings* or the methodologies used, so these new rules will only require approval of the methods used by the board of directors of the NRSRO and that they be compatible with the stated policies of the NRSRO. The method used to generate ratings, changes to ratings methodologies, and discoveries of significant errors in a procedure or methodology must be disclosed, too. This provision responds to an incident about an error in the computer codes used by Moody's to rate a sophisticated type of CDO (CPDO). Upon discovering the error, Moody's changed the ratings procedure, without adjusting the flawed ratings already issued[141].

Furthermore, Section 15E(s) requires that each NRSRO issue a form with each rating, providing key information on the rating and how it was produced, i.e. the assumptions underlying the credit rating procedures and methodologies and the data relied on to produce the rating. This form must be easy to use and helpful, and its content must be directly comparable across types of securities. This requirement is a response to the fact that identical credit ratings implied different default rates with different categories of securities, which was one of the key flaws in the ratings system for structured finance products[142]. Apart from the

[139] Ibid, p. 727
[140] 15 U.S.C. 78o-7(p)(3)(C)
[141] McNamara, p.729
[142] Ibid.

new disclosure requirements, Section 938 prohibits the use of the same rating symbols with different types of securities where different default probabilities apply. Section 15E(s) also calls for disclosure of key qualitative factors behind a rating, along with the main assumptions and principles used in constructing procedures and methodologies. NRSROs must disclose detailed information concerning: (a) the potential limitations of the ratings and the risks not considered in a rating; (b) the uncertainty of a rating, including the reliability, accuracy and quality of the data relied on; (c) the limits and reliability of historical data; and (d) the access to information that would help produce a better rating. Apparently, these requirements respond to failures in the data relied on to produce ratings of structured finance products[143].

Finally, Section 15E(s)(3)(A)(v) requires information regarding the use of due diligence services by NRSROs, and Section 15E(s)(4) requires issuers and underwriters to make such information publicly available and require the due diligence service provider to certify that it has conducted a thorough review of the data, documentation and other relevant information necessary to produce an accurate credit rating. This requirement addresses the lack of investigation of the creditworthiness of the assets underlying many real estate-backed structured finance securities and the lack of interest many investment banks and CRAs had in actually conducting such investigations[144]. Arguably, had such information been available to investors before the crisis, many would have been much more wary of it[145].

4.2. Civil Litigation against Credit Rating Agencies

Historically, CRAs have not been exposed to litigation risks; not even when issuing negligently optimistic ratings. Successful avoidance of litigation has been due to legislative policy and judicial decisions characterizing credit ratings as free speech. CRAs maintained their role as significant financial market participants even after crises – when the flaws in the ratings were evident. CRAs insulated from liability may have a more profitable franchise, albeit this insulation reduces their importance as gatekeepers[146]. For the *gatekeeping* role to function properly, CRAs should need to be able to pledge reputational and economic capital in the event of failed ratings. This can only be achieved through accountability. However, in the aftermath of the 2008 financial crisis, some courts expressed skepticism about the CRAs' free speech claims. This skepticism was also reflected in the Dodd-Frank Act, which marks a turning point in the litigation framework by removing the special treatment for CRAs.

In order for the importance of the changes that the Act makes in CRA accountability to be better understood, a brief outline of the pre-existing legal framework is necessary. Prior to the Dodd-Frank Act, the primary bases for a CRA to be found liable for its activities were: Section 10 and Rule 10b-5[147] of the Exchange Act; state law claims relating to fraud or negligent misrepresentation; and Section 11 of the Securities Act[148].

---

[143] Ibid., p. 730

[144] Ibid.

[145] Ibid., p. 731

[146] Darbellay/Partnoy, p. 5

[147] Rule 10b-5 of the Exchange Act states that: *It shall be unlawful for any person* […]: (a) *to employ any device, scheme, or artifice to defraud,* (b) *to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or* (c) *to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.*

[148] For a further analysis see McNamara, pp. 732-738

In order for a fraud claim to succeed under Rule 10b-5, plaintiffs must allege that the defendant made misstatements or omissions of material fact; with scienter, in connection with the purchase or sale of securities; upon which the plaintiffs relied; and that the plaintiffs' reliance was the proximate cause of its injury. Furthermore, under Section 21D(b)(2) of the Exchange Act, private plaintiffs bringing a case against the CRAs were required to *state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind*. So, a plaintiff would have to prove the CRA's intention to defraud investors by issuing inflated ratings. Arguably, collecting evidence of such a fraud would be quite difficult, making the intention almost impossible to be proved.

Moreover, although state common law negligent misrepresentation doctrines could theoretically provide a possible cause of action against CRAs, such claims have been dismissed by courts on the grounds that credit ratings were opinions, and opinions are not actionable under negligent misrepresentation. In general, the First Amendment has provided an additional defense for CRAs in many cases before the crisis, as they argued that the *actual malice* standard protects issuing credit ratings, much like it does with journalistic statements concerning public figures. This argument was successful due to the initial CRA business model, when ratings were published in manuals paid for and distributed to subscribers. CRAs were (and still are) regarded as companies of widespread interest to the investing public and credit ratings were perceived as opinions rather than statements of fact, thus protected by the First Amendment. Later on, CRAs sought for this argument to also be applied to their structure finance activities, but with uncertain success. After the crisis, jurisprudence is no more consistent on the issue. Certain courts[149] rejected the CRAs' argument that the First Amendment should shield them from all liability and accepted claims of negligent misrepresentation against them. In particular, ratings of structured finance products were distinguished from those deserving the protection of the *actual malice* standard, on the grounds that the former were addressed to a specific group of investors and thus were not of public concern. As of today, the status of the First Amendment defense is uncertain when applied to structured finance ratings.

The third claim against CRAs – that of Securities Act Section 11 – was even weaker and has been rejected in courts, too[150]. More specifically, Section 11 of the Securities Act provides for civil liability for untrue statements of material fact contained in a registration statement, or omissions of such facts, on the part of signers of the registration statement, directors or partners of the issuer, persons named in the registration statement as becoming a director or partner, experts furnishing opinions to be used in the registration statement and underwriters. Although this Rule could apply to CRAs, it was blocked by Rule 436(g) of the Securities Act, which exempted credit ratings from being considered part of the registration statement, thus rendering the likelihood of success of such a claim quite remote. As CRAs could not be held responsible as experts, the only argument the plaintiffs could use was that CRAs were in fact statutory underwriters[151] of complex finance products, because of their active involvement in structuring them. This argument did not stand up in court, on the ground that no matter how expanded the definition of "underwriter" may be, CRAs could not be included.

[149] E.g. in *Anschutz v. Merrill Lynch* the Northern District of California allowed a claim of negligent misrepresentation to proceed under California law.
[150] E.g. *In re Lehman Brothers Mortgage-Backed Securities Litigation*
[151] Securities Act Section 2(a)(11)

Contrary to the extensive protection offered to CRAs under that legal landscape, the Dodd-Frank Act – in an attempt to remedy regulatory failures with increased exposure to litigation risk – imposes two significant changes with respect to the first and third legal bases, by removing the CRAs' relative immunity and nullifying Rule 436(g), so that CRAs are now deemed to be experts. Nevertheless, it does not address the second one (i.e. defense under the First Amendment), leaving the issue yet unsettled with regards to cases on ratings of structured finance products.

To begin with, Section 933 of the Dodd-Frank Act (*State of Mind in Private Actions*) expands the potential legal liability of CRAs in various ways[152]. Section 933(a) specifies that CRAs should be as liable for misconduct as other gatekeepers such as accounting firms or securities analysts, so the exemption from liability threats is now eliminated. Furthermore, there is now established legal liability under Section 21E of the 1934 Securities Act for misstatements in any forward-looking statements made by the CRAs. More specifically, Section 933(b)(2) makes it sufficient to prove that CRAs knowingly or recklessly failed to conduct a reasonable investigation or to obtain reasonable verification of factual elements relied upon by their methodology[153]. Contrary to the heightened pleading standards of the previous[154] litigation framework, an exception from the standards of Section 21D(b)(2) of the Securities Exchange Act is made. According to this exception, the level of scienter a plaintiff is required to demonstrate in a Rule 10b-5 complaint against a CRA is lowered significantly, so that all a plaintiff must now prove is a knowing or reckless failure to examine the creditworthiness of the rated securities. However, by listing two specific failures, either of which is sufficient for a plaintiff to overcome a motion to dismiss, the Act offers the CRAs a *safe harbor* against such complaints[155]. CRAs can defend themselves against securities fraud suits by documenting their due diligence efforts, for example by obtaining a due diligence report. Therefore, Section 933 gives with one hand what the other takes away; lowering the bar to securities fraud actions is counterbalanced by simultaneously providing for the CRAs a valuable safe harbor from such suits. Arguably, CRAs should not expect an increase in liability for ratings under securities fraud actions; instead, they will most likely carefully document their investigation of the underlying assets their ratings are intended to assess, or ensure that the firm with which they contract to perform due diligence on the assets does so[156].

Additionally, Section 939G of the Dodd-Frank Act nullifies Rule 436(g) of the Securities Act, which stated that credit ratings *shall not be considered a part of the registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act*. The repeal of Rule 436(g) implies that CRAs are deemed to be experts under Section 11 and, thus, furthers the policy of placing the CRAs on an equal footing with other experts who function as gatekeepers to the capital markets. The effect of repeal of 436(g) is to expose CRAs to lawsuits under Section 11 of the Securities Act, which subjects issuers, underwriters and

[152] McClintock/Calabria, p. 30
[153] Darbellay/Partnoy, pp. 20-21
[154] Especially Section 21D of the Exchange Act, which was enacted by Private Securities Litigation Reform Act and specified that, for any claim seeking money damages *only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind*.
[155] McNamara, pp. 739-742
[156] Ibid.

experts to civil liability for misstatements or omissions in registration statements, using a strict liability standard. Given that disclosure rules require the filing of written consents by experts, issuers will have to seek CRAs' written consent if they want to use ratings in registration statements. If CRAs grant their consent, they are liable as experts under Section 11[157]. Because of the far-reaching effects of Rule 436(g) nullification, CRAs acted immediately to prevent its implementation, by announcing that they would not consent to the inclusion of their ratings in registration statements[158]. As a result, the market suffered a standstill and the SEC, to prevent further damage, issued a statement that it would not require consents of the CRAs to be included in registration statements. This no-action letter was later extended indefinitely and the SEC has effectively voided the Section 939G of the Dodd-Frank provision.

To sum up, the overall approach of the Dodd-Frank Act with regard to CRAs litigation is quite complex; evaluation of the new landscape must take under consideration the existing provisions of federal securities law, as well as the possible final line of defense, the protection offered to the CRAs under the First Amendment as issuers of opinions[159].

4.3. Reliance on Credit Ratings

In the aftermath of the 2007-2008 financial crisis, regulators in several jurisdictions across the world agreed on the importance of reducing statutory reliance on credit ratings. This objective was expressed in the summit declaration of the G20's and was further on incorporated in the FSB Principles on CRAs. U.S. regulators also shared this objective and, consequently, the SEC included in the 2008 Summary Report bold proposals towards removing credit ratings references from almost all relevant regulations. Although these aggressive proposals were deferred at first[160], part of them was eventually passed in the Dodd-Frank Act. On the basis of the Congress's findings[161], especially that inaccurate credit ratings on structured finance products contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the U.S. and around the world, it was required that regulators remove dependence on external ratings from their rules and regulations.

In fact, the law takes a serious step toward reducing the regulatory reliance on credit ratings by removing such references in many regulations, statutes and other rules. First and foremost, Section 939(a-f) of the Dodd-Frank Act expressly removes statutory references to ratings. Even though Congress included the most important references to ratings into the amendment, such as all banking[162] and securities references[163], it does not call for removal of every such reference. As a result, statutory references to external ratings can still be found after passing the Act in several provisions: such as with respect to student loans, with respect to highways and infrastructure finance, and with respect to telephone media rules and loan guaranties[164].

---

[157] Darbellay/Partnoy, pp. 20-21
[158] McNamara, pp. 739-742
[159] Ibid., p. 731
[160] Duponcheele/Perraudin/Totouom-Tangho, p. 2
[161] Dodd-Frank Act, Section 931(5)
[162] Ibid., Section 939(a-d) and (f)
[163] Ibid., Section 939(e)
[164] Darbellay/Partnoy, p. 21

Additionally, Section 939A of the Dodd-Frank Act requires all federal agencies to review their existing regulations and to provide alternative standards of credit risk assessment. Pursuant to Section 939A, every federal agency has one year to remove regulatory reliance on external (i.e. CRA-issued) credit ratings, so that references to ratings will eventually be removed from every type of governmental rule. However, regulators have moved slowly on this provision and show an overall resistance to abandoning reliance on credit ratings[165]. Evidently, U.S. legislators chose to leave considerable discretion to regulators on the sensitive matter of deciding reliable alternative ways of assessing creditworthiness. Congress does not propose substitutes for CRA ratings; it only seeks to incentivize regulators to come up with the solution of the problems caused of statutory overreliance on CRAs. Perhaps, legislators either were not ready to propose a tested solution or did not wish for the matter to be regulated uniformly, as credit risk assessment methods can vary widely with respect to the different objectives of each supervised entity. Nevertheless, for Section 939A to have real impact and for regulatory licenses power of the CRAs to be eliminated, it may well take the continued involvement of Congress.

Furthermore, although Congress did not require for the private sector to eliminate references to credit ratings, the agency reform should be interpreted as an important message coming from the legislators[166]. Every market participant with investment guidelines or other internal rules concerning the creditworthiness of the assets they hold should realize that such guidelines or rules should not hardwire external ratings in them. Institutional investors, more importantly, should change the practice of relying on external ratings solely and establish alternative methods of credit risk assessment.

[165] McClintock/Calabria, p. 31
[166] Darbellay/Partnoy, p. 21

Table 4: Most Common Raters[167]

A. Securities Rated by One Agency Only

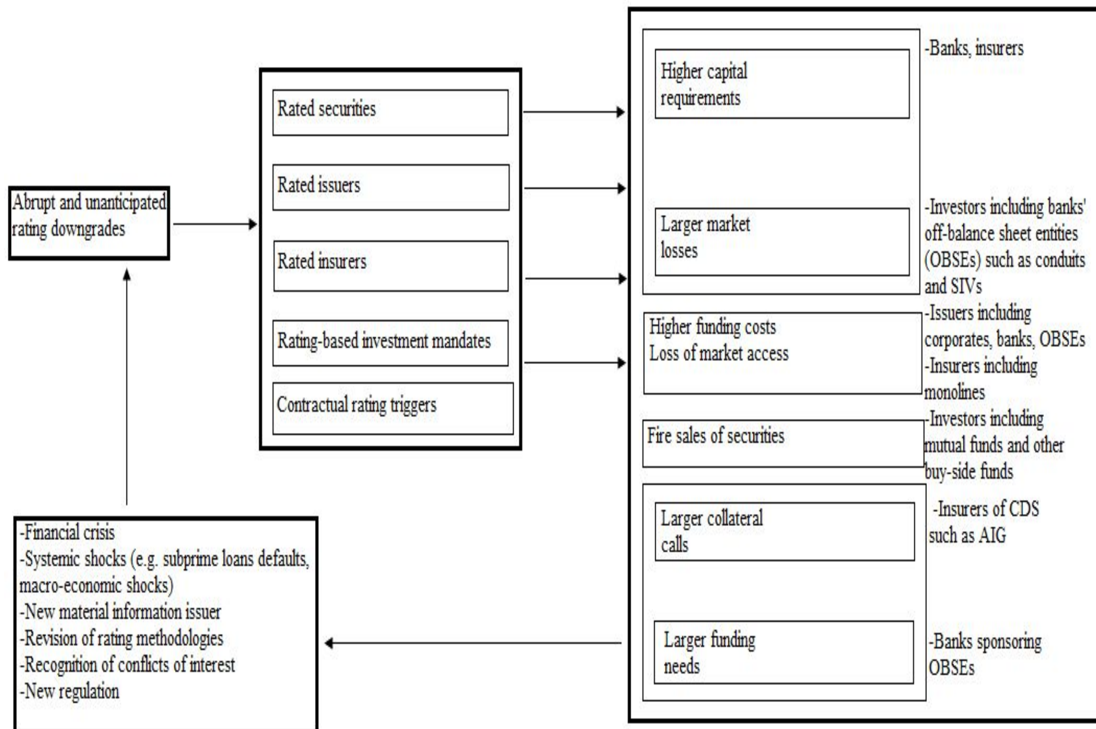
	Fitch	Moody's	Standard & Poor's	Total
Pre-2004	20 (15.04%)	21 (15.79%)	92 (69.17%)	133 (100.00%)
2004	66 (15.03%)	32 (7.29%)	341 (77.68%)	439 (100.00%)
2005	97 (12.47%)	46 (5.91%)	635 (81.62%)	778 (100.00%)
2006	162 (41.33%)	56 (14.29%)	174 (44.39%)	392 (100.00%)
2007	29 (30.85%)	27 (28.72%)	38 (40.43%)	94 (100.00%)
Entire Period	374 (20.37%)	182 (9.91%)	1,280 (69.72%)	1,836 (100.00%)

B. Securities Rated by Two Agencies

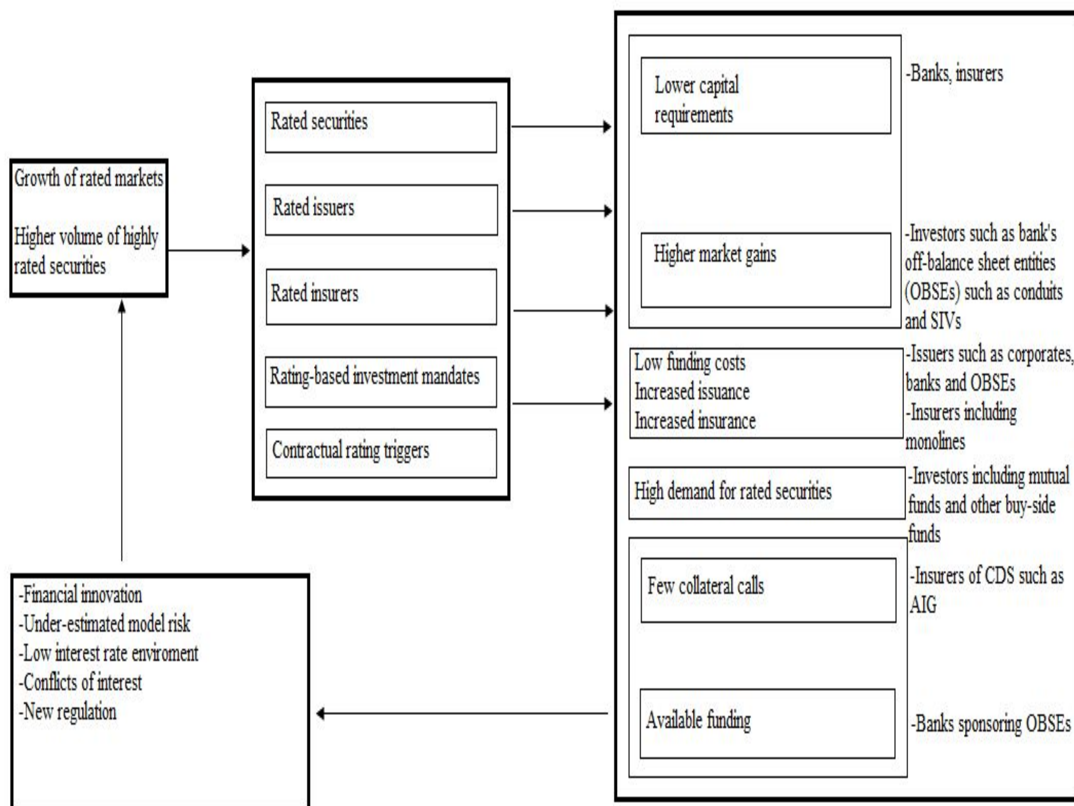
	Standard & Poor's and Moody's	Standard & Poor's and Fitch	Moody's and Fitch	Total
Pre-2004	402 (73.09%)	86 (15.64%)	62 (11.27%)	550 (100.00%)
2004	1,695 (85.05%)	225 (11.29%)	73 (3.66%)	1,993 (100.00%)
2005	4,413 (82.29%)	566 (10.55%)	384 (7.16%)	5,363 (100.00%)
2006	6,433 (92.12%)	313 (4.43%)	314 (4.45%)	7,060 (100.00%)
2007	2,323 (93.71%)	75 (3.03%)	80 (3.23%)	2,478 (100.00%)
Entire period	15,266 (87.51%)	1,265 (7.25%)	913 (5.23%)	17.444 (100.00%)

[167] Benmelech/Dlugosz, p. 193

Tables 5 and 6: The Systemic Risk of Credit Rating Downgrades (Bust and Boom Cycle)[168]



[168] Sy, pp. 31-32


Growth of rated markets
Higher volume of highly rated securities
Rated securities
Rated issuers
Rated insurers
Rating-based investment mandates
Contractual rating triggers
Lower capital requirements
-Banks, insurers
Higher market gains
-Investors such as bank's off-balance sheet entities (OBSEs) such as conduits and SIVs
Low funding costs
Increased issuance
Increased insurance
-Issuers such as corporates, banks and OBSEs
-Insurers including monolines
High demand for rated securities
-Investors including mutual funds and other buy-side funds
Few collateral calls
-Insurers of CDS such as AIG
Available funding
-Banks sponsoring OBSEs
-Financial innovation
-Under-estimated model risk
-Low interest rate enviroment
-Conflicts of interest
-New regulation

Section C: European Responses for the Regulation on Credit Rating Agencies

I. Evolution of Legislation: from the de Larosière Report to the Regulation on Credit Rating Agencies

1. Preliminary Thoughts on Adopting Rules on Credit Rating Agencies

The need for establishing a regulatory framework with regard to CRAs was examined by the European Commission for the first time in 2004. Following the relevant call for advice, the Committee of European Securities Regulators (CESR) submitted CESR's Technical Advice on possible measures concerning CRAs in March 2005, in which the regulatory framework then in force was evaluated as sufficient for addressing the issues arising from CRAs' functions[169].

After the collapse of Enron, the Commission held several discussions to assess the need for appropriate legislative proposals to deal with the activities of CRAs. On March 11th, 2006 the Commission published a Communication, in which it stated that within the EU, there are three Financial Services Action Plan (FSAP) Directives that are relevant to CRAs: (a) the Market Abuse Directive (MAD); (b) the Capital Requirements Directive (CRD); and (c) the Markets in Financial Instruments Directive (MiFID).

Although, credit ratings do not constitute a recommendation within the meaning of the MAD nor the issuing of a rating would normally result in the CRAs providing investment advice within the meaning of Annex I to MiFID, the CRD provides for the use of external credit assessments in the determination of risk weights applied to a firm's exposures. Only the use of assessments provided by recognized External Credit Assessment Institutions (ECAIs), mainly CRAs, are acceptable to the competent authorities. The CRD allows Member States to recognize an ECAI as eligible in two ways: (a) direct recognition, in which the competent authority carries out its own assessment of the ECAI's compliance with the CRD's eligibility criteria; and (b) indirect recognition, in which the competent authority recognizes the ECAI without carrying out its own evaluation, relying instead on the recognition of the ECAI by the competent authority of another Member State. Therefore, credit ratings had been hard-wired into the EU legislation for the same purposes as in the U.S. financial legislation.

Later on, the CESR's Report was updated to take into account the experience of the global financial crisis of 2007-2009, especially the role of CRAs in the market of structured finance instruments. Therefore, the CESR's Second Report to the EU Commission on the compliance of CRAs with the IOSCO Code and the role of CRAs in structured finance was submitted in May 2008.

Although the system of self-regulation that was suggested by the CESR was ultimately discarded for a more efficient regulatory system based on supervision, the CESR's Reports were the foundation for EU legislators' approach to CRA regulation. More specifically, the suggestions of the CESR's Reports for resolving conflicts of interest in credit rating activities by strengthening corporate governance, internal controls, disclosure and transparency were clearly reflected in the legislation that followed. CESR's Reports' suggestions on the issues of unsolicited ratings and of excessive reliance on CRA ratings were also incorporated in the legislation regulating CRAs.

---

[169] Mastromanolis, p. 79

Meanwhile, the global financial crisis of 2007-2009 brought the spotlight on the weaknesses of financial supervision. Therefore, in November 2008, the Commission mandated a High-Level Group chaired by Jacques de Larosière to make recommendations on how to strengthen European supervisory arrangements with a view to better protecting the citizen and rebuilding trust in the financial system. In its final report presented on February 25th, 2009 (the 'de Larosière Report'), the High-Level Group recommended that the supervisory framework be strengthened to reduce the risk and severity of future financial crises.

With regard to CRAs, the de Larosière Report cited the two main shortcomings. First, CRAs lowered the perception of credit risk by giving AAA ratings to the senior tranches of structured finance products – like CDOs – the same rating they gave to government and corporate bonds yielding systematically lower returns. Second, flaws in rating methodologies were the major reason for underestimating the credit default risks of instruments collateralized by subprime mortgages. Moreover, the Report was especially critical of certain factors, which were all felt to have contributed to the poor rating performances of structured products. Such factors included: (a) the lack of sufficient historical data relating to the U.S. subprime market; (b) the underestimation of correlations in the defaults that would occur during a downturn; and (c) the inability to take into account the severe weakening of underwriting standards by certain originators.

The de Larosière Report also recommended reforms to the structure of supervision of the financial sector in the EU. The group concluded that a European System of Financial Supervisors (ESFS) should be created, comprising three European Supervisory Authorities (ESAs), one for the banking sector (European Banking Authority – EBA), one for the securities sector (European Securities and Markets Authority – ESMA) and one for the insurance and occupational pensions sector (European Insurance and Occupational Pensions Authority – EIOPA). Finally, it recommended the creation of a European Systemic Risk Council. This was suggested because global finance markets had evolved so rapidly that it was impossible for national regulators to keep up with the effective supervision of them.

2. Regulation 1060/2009 (CRA I)

Regulation 1060/2009 of the European Parliament and of the Council on Credit Rating Agencies (CRA I), adopted on September 16th, 2009, was the European legislators' first response to the rationale for the regulation of CRAs. The principal aim of CRA I is to protect the stability of financial markets and investors[170]. It acknowledges that CRAs play an important role in global securities and banking markets. This is because CRA ratings are used by investors, borrowers, issuers and governments as part of making informed investment and financing decisions in addition to the regulatory purposes. Consequently, credit ratings have a significant impact on the operation of the markets and on the trust and confidence of investors and consumers. Therefore, CRA I calls for credit rating activities to be conducted in accordance with the principles of integrity, transparency, responsibility and sound governance in order to ensure that resulting credit ratings used in the EU are independent, objective and of adequate quality[171].

[170] Regulation 1060/2009, Preamble point (7)

[171] Ibid., Preamble point (1)

Since CRAs were considered to have failed to reflect the worsening market conditions on their ratings early enough and therefore omitted to adjust their credit ratings in time following the deepening market crisis, the legislators' main focus was to correct those failures. Consequently, they provided for measures relating to conflicts of interest, the quality of the credit ratings, the transparency and internal governance of CRAs, and the surveillance of CRAs' activities[172]. Moreover, in order to ensure a high level of investor and consumer confidence in the internal market, the conditions and the procedure for the registration of CRAs were defined. Such registration was made a prerequisite for CRAs to issue ratings intended to be used for regulatory purposes[173]. In addition to the registration, an endorsement regime was introduced in order to respond to concerns that lack of establishment in the EU might be a serious impediment to effective supervision of the CRAs[174]. However, legislators wanted to preserve CRAs' independence with regard to the issuing of ratings. Therefore, the competent authorities and the Member States were prohibited from interfering with the substance of credit ratings and the methodologies applied by the CRAs[175], which were not affected by CRA I.

All in all, CRA I's provisions were focused on procedural matters concerning the minimum requirements for CRAs' activities as well as on the systematization of the regulatory framework across the EU. CRA I could be characterized as being a transitional regulation, since it leaves several aspects with regard to CRAs still unregulated and it calls for further research on them[176].

3. Regulation 1095/2010 and the Establishment of ESMA

Meanwhile, in accordance with the Commission's recommendations following the de Larosière Report, in September 2010 the European Parliament and the Council adopted the suggested reforms on financial supervision and passed, among others, Regulation 1095/2010. Thus, the European Securities and Markets Authority (ESMA) was created, as the legal successor of the CESR[177]. ESMA's objective is to protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the EU economy, its citizens and businesses[178]. Aimed at safeguarding the stability in financial markets, ESMA is to contribute to: (a) improving the functioning of the internal market, including in particular a sound, effective and consistent level of regulation and supervision; (b) ensuring the integrity, transparency, efficiency and orderly functioning of financial markets; (c) strengthening international supervisory coordination; (d) preventing regulatory arbitrage and promoting equal conditions of competition; (e) ensuring the taking of investment and other risks are appropriately regulated and supervised; and (f) enhancing customer protection.

4. Regulation 513/2011 (CRA II)

In accordance with the European Council's conclusions of June 19th, 2009 and the Commission's Proposal for a Regulation amending Regulation 1060/2009 ESMA should be

---

[172] Ibid., Preamble point (10)
[173] Ibid., Preamble point (43)
[174] Ibid., Preamble point (14)
[175] Ibid., Preamble point (58)
[176] Mastromanolis, p. 84
[177] Regulation 1095/2010, Article 76 paragraph 4
[178] Ibid., Article 1 paragraph 5

granted adequate supervisory powers, including exclusive supervisory powers over CRAs[179]. Therefore, Regulation 513/2011 of the European Parliament and of the Council (CRA II) was passed in May 2011, with the objective of setting up an efficient and effective supervisory framework for CRAs by entrusting a single supervisory authority (ESMA) with the supervision of CRAs in the EU[180].

CRA II amended CRA I accordingly and resolved several of the latter's insufficiencies. To begin with, the scope of competence of ESMA was clearly defined so that financial market participants could identify the authority competent in the field of activity of CRAs. ESMA was given general competence regarding matters relating to the registration and ongoing supervision of CRAs[181]. Moreover, in order to exercise its supervisory powers effectively, ESMA was given the right to require, by simple request or by decision, all necessary information from CRAs and to conduct investigations and on-site inspections. Finally, the power of imposing periodic penalty payments to compel CRAs to put an end to an infringement, to supply complete information or to submit to an investigation or on-site inspection was also conferred on the ESMA; along with the power to impose fines on CRAs, where it finds that they have committed, either intentionally or negligently, an infringement of Regulation 1060/2009[182].

In addition to ESMA's appointment as supervisor of the CRAs, CRA II included provisions with regard to transparency concerning the historical performance of credit ratings and the quality of the data on which they rely[183].

<u>5. Regulation 462/2013 (CRA III)</u>

In summary, CRA I required for CRAs to comply with rules of conduct in order to mitigate possible conflicts of interest and to ensure high quality and sufficient transparency of credit ratings and the rating processes. Following the amendments introduced by CRA II, ESMA was empowered to register and supervise CRAs. However, the European Parliament's resolution of June 8th, 2011 on CRAs called for enhanced regulation to address a number of issues relating to credit rating activities, including the risk of overreliance on credit ratings and the risk of conflicts of interest stemming from the issuer-pays business model of CRAs. Meanwhile, at the international level, FSB endorsed principles to reduce the reliance of authorities and financial institutions on credit ratings.

Therefore, Regulation 462/2013 of the European Parliament and of the Council (CRA III) was passed in May 2013. CRA III further amends CRA I with the objectives to reinforce the independence of CRAs; to promote sound credit rating processes and methodologies; to mitigate the risks associated with sovereign ratings; to reduce the risk of overreliance on credit ratings by market participants, and to ensure a right of redress for investors[184]. CRA III complements the regulatory framework set forth by CRA I and II by providing solutions to some of the most important issues, such as conflicts of interest arising from the issuer-pays model and disclosure for structured finance instruments.

---

[179] Ibid., Preamble point (5)
[180] Regulation 513/2011, Preamble point (35)
[181] Ibid., Preamble point (5)
[182] Ibid., Preamble points (14), (17) and (18)
[183] Mastromanolis, p. 100
[184] Regulation 462/2013, Preamble point (49)

More specifically, due to the complexity of structured finance instruments, CRAs had not always succeeded in ensuring a sufficiently high quality of credit ratings issued on such instruments and this led to a loss of market confidence in these types of ratings. CRA III includes provisions in order to regain such confidence[185]. Meanwhile, the need to review transparency, procedural requirements and the timing of publication specifically for sovereign ratings was highlighted by the sovereign debt crisis. Thus CRA III includes provisions in view of the specificities of sovereign ratings and in order to avoid a risk of contagion across the EU [186]. Furthermore, in order to increase competition in a market dominated by only three CRAs, measures are taken to encourage the use of smaller CRAs whenever issuers and related third parties seek credit ratings from two or more CRAs[187]. With regard to conflicts of interest, a rotation mechanism for lead rating analysts is suggested, to address the risk of familiarity that arises from the long-lasting relationships between CRAs and the rated entities.

It is also acknowledged by the legislators of CRA III that overreliance on credit ratings should be reduced and all the automatic effects deriving from credit ratings should be gradually eliminated. Therefore, credit institutions and investment firms are encouraged to put in place internal procedures in order to make their own credit risk assessment, while investors are encouraged to perform a due diligence exercise. Within that framework, CRA III suggests that financial institutions should not solely or mechanistically rely on credit ratings[188].

However, as CRAs were (and are still) important participants in the financial markets, their services have a considerable impact on the public interest. Credit ratings, unlike investment research, could no longer be classified as mere opinions about a value or a price for a financial instrument or a financial obligation. Thus, their regulatory value for regulated investors is now recognized in the CRA III. Consequently, the new legislation is aimed at preserving the independency of CRAs and transparency of the rating methods, particularly since credit ratings still drive investment choices because of information asymmetries and for efficiency purposes[189].

Besides, credit ratings, whether issued for regulatory purposes or not, have a significant impact on investment decisions and on the image and financial attractiveness of issuers. Hence, CRAs have an important responsibility towards investors and issuers in ensuring that they comply with Regulation 1060/2009 so that their ratings are independent, objective and of adequate quality. However, investors and issuers are not always in a position to enforce CRAs' responsibility towards them. Therefore, CRA III provides for a right of redress for investors who have reasonably relied on ratings issued in breach of Regulation 1060/2009 as well as for issuers who suffer damage because of ratings issued in breach of Regulation 1060/2009[190]. Under CRA III, it is possible for CRAs to be held liable if they infringe intentionally or with gross negligence any obligations imposed on them by EU law[191].

[185] Ibid., Preamble point (28)
[186] Ibid., Preamble point (44)
[187] Ibid., Preamble point (11)
[188] Ibid., Preamble point (9)
[189] Ibid., Preamble point (8)
[190] Ibid., Preamble point (32)
[191] Ibid., Preamble point (33)

A more detailed outline of Regulation 1060/2009, as amended by Regulation 513/2011 and Regulation 462/2013, is the subject of the following chapters of this paper.

II. Use and Certification of Credit Ratings for Regulatory Purposes

1. Use of Credit Ratings

According to Article 4 of Regulation 1060/2009, only credit ratings issued by CRAs established in the EU and registered under the Regulation's provisions can be used for regulatory purposes by credit institutions, investment firms, insurance and reinsurance undertakings, institutions of occupational retirement provision, management companies, investment companies, and alternative investment fund managers and central counterparties. Moreover, references to ratings in financial prospectuses need to be accompanied by information on the issuing CRA's status according to the Regulation. Credit ratings should be published either on the CRA's website or by other means, or distributed to subscribers.

Credit ratings issued outside the EU can be used for regulatory purposes only after they are endorsed by a CRA registered in the EU, which has to certify that rating activities comply with certain conditions. More specifically, each CRA can only endorse ratings issued abroad either in whole or in part by firms belonging to the same corporate group in which the CRA is included. Thus, the endorsing CRA must be able to provide verifications to the ESMA that the conduct of the processes applied to issue the ratings-to-be-endorsed fulfils the requirements set out by CRA I. Furthermore, ESMA should be given unlimited access to all the necessary information for monitoring and assessing the compliance of the foreign CRA with the European standards. Such foreign CRA must be authorized and supervised by the third country's authorities, under a regulatory regime that safeguards the independence of the rating activities from interference by public authorities.

In addition, a functioning cooperation agreement between ESMA and the third country's relevant supervisory authority must be in effect, in which the mechanism for the exchange of information between the authorities and the procedures for coordinated supervision activities should be specified. If such cooperation arrangements are operational and the Commission has acknowledged the equivalence of the foreign supervisory system to the European system, the endorsing CRA does not need to prove the independence of the rating process in the foreign regulation. Lastly, the issuance of the rating outside the EU must be justified by an objective reason. Evidently, for ratings issued abroad to be used for regulatory purposes in the EU, the law requires that both foreign CRAs and foreign supervisory authorities agree on a system of "joint supervision" by acknowledging certain supervisory powers to the ESMA.

Credit ratings issued in third countries in accordance with those standards are eligible for endorsement by CRAs registered in the EU, which bear responsibility for the compliance of such endorsed ratings with the European standards. However, registered CRAs should not misuse the endorsement facility by benefiting from it with the intention of circumventing European law requirements concerning the issuance of credit ratings.

2. Equivalence and Certification Based on Equivalence

Apart from the endorsement process outlined above, credit ratings of entities established in third countries or of financial instruments issued outside the EU by CRAs established in such third countries can also be used in the EU. These ratings from third countries will be accepted in the EU, without being endorsed by a registered CRA, on certain conditions, which are outlined below. Firstly, the issuing CRA needs to be authorized and subject to supervision in

its home country. Secondly, the foreign regulatory framework with regard to CRAs must have been recognized by the Commission as equivalent to that of CRA I. More specifically, the legal and supervisory framework of a third country may be considered equivalent according to the relevant Commission's equivalence decision if: (a) it ensures that authorized CRAs in that country comply with legally binding requirements equivalent to those of Articles 6 to 12 and Annex I of Regulation 1060/2009[192]; (b) it provides for effective supervision and continuing enforcement of these requirements; and (c) if it is adequate to prevent interference of the foreign country's public authorities with the content and methodologies of credit ratings.

The third condition calls for the establishment of operational cooperation arrangements between the ESMA and the relevant supervisory authorities of the third country, in which the mechanism for the exchange of information between supervisors and the procedures concerning the coordination of supervisory activities need to be defined.

In addition, the foreign CRA has to be certified by the ESMA, which decides upon such certification application in accordance with the procedure followed for the registration of domestic CRAs[193]. However, a foreign CRA may be exempted from complying with the requirements concerning its organizational structure[194], the rotation mechanism of analysts[195] and/or from the requirement of the physical presence in the EU. For the exemption application to be successful, the CRA has to demonstrate that the requirements are too burdensome and disproportionate in view of the nature, scale and complexity of its business. The exemption application is submitted together with the certification application; ESMA, when examining it, is to take into consideration the impact of the credit ratings on the financial stability of the Member States. The ratings issued abroad should not be of systemic importance to the financial stability or integrity of the financial markets of one or more Member States. Finally, the abovementioned criteria may be further specified or amended by the Commission, in order to keep up with the developments of financial markets.

III. Independence and Avoidance of Conflicts of Interest

Given that lack of independence was found to be one of the core issues concerning CRAs and their involvement in the global financial meltdown of 2007-2008, Regulation 1060/2009 includes a compact set of provisions aiming to regulate all sorts of conflicts of interest, both existing and potential, that may affect the rating process. These conflicts of interest can arise, on the one hand, between the CRA and its shareholders, managers, rating analysts, employees or other persons whose services are placed at the disposal of the CRA or are linked to the CRA either directly or indirectly; and, on the other hand, within the CRA's rating and other commercial businesses[196]. As a result, the law requires that CRAs establish and maintain an internal control structure to enforce the policies and procedures that have been adopted to ensure the independence of the persons mentioned above and, thus, the integrity of credit ratings by preventing and mitigating possible conflicts of interest at any level. Furthermore,

---

[192] With the exception of Articles 6a, 6b, 8a, 8b, 8c and 11a, point (ba) of point 3 and points 3a and 3b of Section B of Annex I of the CRA III Regulation

[193] Regulation 1060/2009, Articles 15, 16 and 18

[194] Ibid., Section A of Annex I

[195] Ibid., Article 7(4) and Section C of Annex I

[196] Ibid., Article 6(1)

standard operating procedures (SOPs) with regard to corporate governance and the organization of the CRAs should be established and updated when necessary[197].

1. Organizational Requirements concerning Conflicts of Interest

The organizational requirements set forth with the CRA Regulation[198] cover a wide field of corporate governance issues; including the staffing and the responsibilities of the CRAs' supervisory or administrative boards, the CRAs' internal control mechanisms, and the establishment of independent compliance departments and functions responsible for reviewing rating methodologies.

With regards to the senior management, CRA I mandates that it is adequately skilled and that the majority of its members have sufficient expertise in financial markets – as well as in structured finance products, if the agency issues such ratings – to guarantee a sound and prudent management. More specifically, one third (and in any case at least two) of the members of the CRA's administrative or supervisory board need to be independent, which means that they are not involved in the rating activities. These members are responsible for the specific tasks of monitoring the rating methodologies, the internal quality control system, the elimination and disclosure of conflicts of interest, and the efficiency of the functions for reviewing ratings performance. ESMA may ask for the independent members' reports on these issues. For the impartiality of the independent members to be ensured, their compensation should not be linked to the CRA's business performance and their service should be for a fixed period (five years). Meanwhile, the supervisory board in general is responsible for ensuring the independence of credit rating activities from political and economic influences, the proper management of all conflicts of interest and the overall compliance with the Regulation's provisions.

With regard to the compliance department that needs to be established within every CRA, it is required that it operates independently; therefore, it should be given adequate resources and access to all relevant information and its staff should not be involved in the rating process in any way. The compliance department's main task is to assess the adequacy of the policies adopted to ensure CRA's compliance with the regulatory framework of CRA I, to address any deficiency in such policies, and to advise the managers and the rating analysts on best practices on how to comply with their legal obligations.

In addition to the compliance department, an independent review function established in each CRA is responsible for reviewing the methodologies, models and key rating assumptions, especially their appropriateness when applied for assessing the creditworthiness of new financial instruments. Finally, CRAs are required to employ effective procedures in order to guarantee the quality, continuity and regularity of their rating performance and should dispose sufficient resources and for this purpose.

2. Operational Requirements concerning Conflicts of Interest

There are also provisions for operational requirements[199]. The intent of these provisions is to eliminate conflicts of interest which may arise either as a result of the issuer-pays operating model of the CRAs, or due to CRAs providing services other than credit ratings (ancillary

[197] Ibid, Article 6(4)
[198] Ibid., Annex I Section A
[199] Ibid., Annex I Section B

services). With regard to the ownership links between CRAs, their rating analysts and the rated entities, CRAs are required to disclose publicly from which clients they receive more than 5% of their annual revenue.

Furthermore, CRAs are prohibited from issuing ratings in certain circumstances, such as: (a) if the CRA or any natural person involved in its rating activities has an ownership interest in the rated entity or the financial instruments that are being rated; (b) if a shareholder or member of the CRA holding 10% or more of its capital or being otherwise in a position to influence its business either holds at the same time 10% or more of the rated entity's capital or participates in the rated entity's management; (c) if the CRA is directly or indirectly linked to the rated entity, especially if the latter holds more than 10% of the CRA's capital or voting rights. Notwithstanding the prohibition, if such a rating has already been issued, the CRA must immediately assess whether there are grounds for reviewing or withdrawing it. The law is more lenient for shareholders of a CRA holding 5-10% of its capital who at the same time hold 5-10% of the rated entity's capital or participate in the rated entity's management; in this case, the issuing of ratings is generally allowed on condition that the probability of conflicts is disclosed publicly.

Moreover, CRA I demands that CRAs charge their clients for the services provided with fair and equal fees based on actual costs and by no means dependent on the level of the issued ratings or the outcome of the distribution of the rated instruments in the financial markets. CRAs may indeed provide services other than the issue of credit ratings; mainly data analysis and market distribution services. Nevertheless, in order to prevent conflicts of interest between the credit rating and the ancillary business activities within the same CRA, it is ordered that the provision of such services is disclosed publicly and that rating analysts abstain from advising, either formally or informally, on the design of structured finance products.

Finally, CRA Regulation calls for CRAs to keep records and audit trails of their credit rating activities for at least five years. ESMA can ask to be given access to these records, which include, amongst other information: (a) the identity of the persons participating in each rating; (b) information as to whether a rating is solicited or unsolicited; (c) the account records for fees received from the rated entity and the subscribers to whom it was distributed; (d) the methodologies used in the rating process; (e) the procedures implemented to ensure the CRA's compliance; and (f) copies of internal and external communications relevant to the rating process.

<u>3. Requirements for Rating Analysts and Employees of the Credit Rating Agencies</u>

In addition to the general provisions aiming to prevent conflicts of interest at the agency level or among the different business activities within a CRA, Regulation 1060/2009 includes specific terms and conditions concerning the rating analysts and other natural persons involved in the credit rating activities[200]. Apart from ensuring that rating analysts are adequately qualified, a CRA must also take care that they do not participate in negotiations with the rated entities regarding fees or payments. Besides, the analysts' compensation and performance evaluation must not be contingent on the revenue derived from the rated entities.

[200] Ibid., Article 7

In order to address conflicts caused by the continued occupation of the same persons in certain rating activities, paragraph 4 of Article 7 sets a gradual rotation mechanism with regard to the rating analysts. More specifically[201], it is stipulated that the lead analysts are not involved in rating activities related to the same entity for more than four years. In case of unsolicited ratings or sovereign ratings, the issuing CRAs must provide for the rotation of the analysts who are engaged in such rating activities related to the same entity at least every five years and the persons who approve such ratings at least every seven years. A “cooling off” period of two years is required after the completion of the above tenures.

Moreover, to shield the independence and objectivity of the analysts, the law prohibits them from engaging in transactions related to financial instruments issued by rated entities within their area of primary analytical responsibility – let alone owning such financial instruments. Persons who have had a recent employment or other relationship that can possibly cause conflicts of interest with a rated entity cannot qualify as analysts of this entity’s or its financial instruments’ creditworthiness for ratings; and vice versa, when an analyst leaves from a CRA to join a firm for which they have provided credit ratings, the relevant work of this analyst needs to be reviewed by the CRA. Nevertheless, analysts who are later employed by a rated entity are on six month probation from taking up key management positions with their new employees. Finally, rating analysts are reasonably prohibited from soliciting or accepting money, gifts or other favors from the CRA’s clients.

CRAs, on their part, are obliged to guarantee the confidentiality of the information entrusted to them for the purpose of credit ratings. Consequently, they shall ensure: (a) that the rating analysts do not use such information for the purpose of trading financial instruments or share it with anyone who is not directly involved in the rating activities; (b) that they do not disclose information on future ratings except to the rated entities; and (c) that they take all necessary measures to protect such information from fraud, theft or misuse.

4. Exemption from Requirements concerning Conflicts of Interest

Although CRA Regulation is quite thorough on the subjects of avoiding and addressing conflicts of interest, it also provides for an exemption from some of these rules, based on proportionality[202]. More specifically, if a CRA demonstrates to the ESMA that the requirements with regard to the staffing of the supervisory board and the number of its independent members, with regard to the establishment of the compliance and the review functions, and/or with regard to the rating analysts rotation mechanism are disproportionate in view of the nature, scale and complexity of its business and the range of its ratings; then it can be exempted from complying with some or all of these requirements. The exemption is granted on condition that: (a) the CRA employs less than 50 people; (b) that it has implemented equivalent procedures to guarantee the independence of the rating analysts; and (c) that the CRA’s size is not determined in such a way as to bypass compliance requirements. In any case, ESMA ensures that at least one CRA in each group of CRAs is not exempted from complying with the Regulation’s requirements.

5. Conflicts of Interest concerning Investments in Credit Rating Agencies

In an attempt to incentivize a healthy competition in the credit rating industry, the legislators of the CRA Regulation included Article 6a to prevent oligopoly in the credit rating industry.

[201] Ibid., Annex I Section C paragraph 8

[202] Ibid., Article 6 paragraph 3

Therefore, any shareholder who holds at least 5% of either the capital or the voting rights of a certain CRA is prohibited from having the power to exercise control over any other CRA. Such control or dominant influence could be a result of this shareholder holding simultaneously 5% or more of the capital or the voting rights of another CRA, or having the right to appoint the members of another CRA's management board – let alone being a member of such a board. However, the prohibition does not apply to holdings in diversified collective investment schemes[203], which are not accompanied by the right for the investor to influence the schemes' business and, therefore, are exempted from the 5% limit. Naturally, the prohibition does not apply to investments in CRAs belonging to the same corporate group.

IV. Rules on the Issuing of Credit Ratings

1. General Rules on Credit Rating Methodologies, Models and Key Rating Assumptions

With Regulation 1060/2009, European legislators set some minimal standards for rating methodologies, models and key assumptions, in an attempt to ensure the quality of the credit ratings[204]. Consequently, CRAs are demanded to analyze thoroughly, by applying the relevant rating methodologies, all available information with regard to each rating; and such information must be of sufficient quality and obtained from trustworthy sources. Although ratings are supposed to be the outcome of systematic application of the appropriate methodologies on reliable information, they still are CRAs' opinions and need to be relied upon to a limited degree. Those limitations need to be disclosed in each rating. Moreover, rating methodologies should be subject to validation based on historical experience; to facilitate such back-testing by all market participants, the law requires that CRAs disclose their methodologies publicly.

When a CRA intends to either make material changes to an existing methodology or apply a new one, it must publish such proposed changes on its website explaining the underlying reasons and estimated implications of them. The new methodology can only be implemented after one month of the publication date, during which stakeholders are invited to submit comments. Nevertheless, changes of past ratings must always be in accordance with the CRA's published methodologies.

More specifically, when rating methodologies, models or key rating assumptions are altered for compliance reasons, the CRA imposing the changes must immediately – apart from informing the ESMA accordingly – disclose which ratings are likely to be affected, using the same means of communication as used for the distribution of these ratings, and publish the changes along with a detailed explanation of them and the consultation comments regarding them on its website. Furthermore, the CRA must impose the affected ratings under observation, review them within six months after the application of the changes and, ultimately, issue new ratings for the concerned assets, if necessary.

In the scope of safeguarding the quality of credit ratings in the long-term, CRA Regulation stipulates that CRAs monitor existing ratings and review their methodologies at least annually[205], taking into consideration specifically the impact that developments in macroeconomic and financial markets conditions might have on ratings. When those reviews result in identifying deficiencies in the methodologies or the application of them, CRAs must correct such errors

[203] E.g. pension funds or life insurance funds

[204] Regulation 1060/2009, Article 8

[205] Sovereign ratings must be reviewed at least every six months.

as soon as possible and follow a notification and disclosure procedure similar to the one described above for changes in the methodologies.

2. Rules on Sovereign Ratings

Since the role of CRAs in the global meltdown was mostly evident in structured finance products and sovereign ratings, CRA I includes detailed regulations with regard to them. As far as sovereign ratings are concerned, they should incorporate a detailed analysis of each country's specific characteristics, while revision of the creditworthiness of a given group of countries is permitted only if it is accompanied by individual country reports, which are publicized along with the revision[206]. Moreover, CRAs' public communications on potential updates of sovereign ratings are required to be based on information that is either available from generally accessible sources or disclosed with the consent of the relevant state's authorities. In order to protect financial stability in the EU, the legislators created a strict regulatory system for the issuing of sovereign ratings, under which the CRAs are allowed to publicize unsolicited sovereign ratings on no more than three Fridays within a year and only after they have notified the ESMA and the public accordingly. Deviation from this calendar is permitted only for compliance reasons. EU legislators chose Friday as the publication date, in an attempt to ensure that, in the event of a downgrade, the rated countries/authorities are provided with a weekend's time to take measures on improving their creditworthiness profile before the regulated markets open.

3. Rules on Ratings on Structured Finance Instruments

An even stricter and more detailed system is prescribed with regard to the issuance of ratings on structured finance instruments. First, ESMA is stipulated to develop draft regulatory technical standards concerning the disclosure of relevant information and to set up a website for the publication of such information on structured finance products[207]. Then, the issuers, the originators and the sponsors of structured finance instruments are required to jointly publish information on the credit quality and performance of the underlying assets; the structure of the securitization transaction; the cash flows and any collateral supporting exposure, as well as sufficient information so that other market participants are enabled to conduct reliable stress-tests on their own. However, the obligation for publication is restricted by laws protecting the confidentiality of information sources and the processing of personal data.

In addition to the publication and disclosure requirements, it is also ordered that the issuers appoint at least two CRAs to provide solicited ratings on structured finance instruments independently of each other[208]. Naturally, these two CRAs cannot belong to the same corporate group nor be in a position to exercise a dominant influence on any other CRA through investment, agency or management correlations. Furthermore, in an attempt to incentivize healthy competition in the credit rating industry, CRA I suggests that whenever an issuer intends to appoint more than one CRA for assessing the creditworthiness of the same issuance or entity – let alone when this is done to comply with legal obligations – this issuer shall consider that at least one of the appointed CRAs has less than 10% of the total market share[209]. Nevertheless, issuers may decide differently if they estimate that there is no such

[206] Regulation 1060/2009, Article 8a
[207] Ibid., Article 8b
[208] Ibid., Article 8c
[209] Ibid., Article 8d

CRA capable of rating the relevant issuance or entity. The information needed for this evaluation is to be provided by the ESMA on its website.

Finally, a CRA cannot refuse to produce a credit rating on the sole reason that a portion of the underlying assets of the structured finance product whose creditworthiness is being assessed has already been rated by another CRA[210]. However, the CRA in charge is not obliged to follow the existing ratings, on condition that such differentiation is adequately justified.

V. Transparency and Disclosure Requirements

1. Presentation of Credit Ratings

The CRA Regulation encompasses detailed provisions with regard to the appropriate presentation and disclosure of credit ratings and rating outlooks, which shall not reflect factors other than those related to the assessment of creditworthiness[211]. Generally speaking, all credit ratings and rating outlooks as well as any decision to discontinue a certain rating need to be disclosed by the CRAs in a fair and timely manner.

More specifically, CRAs upon publishing a rating shall ensure that: (a) all significant information used for preparing the rating is illustrated, along with an indication as to whether the rating has been disclosed to the rated entity and amended accordingly following that disclosure before being published; (b) the principal methodology or version of it that was used for the rating is indicated and comprehensively explained; (c) a thorough explanation of the meaning of each rating category – of the definition of 'default' and 'recovery' – and of the risk warnings is provided; (d) the dates of first release and of all updates concerning the rating are clearly indicated; (e) information as to whether the rating concerns a new financial product or whether the CRA has rated such a product before is provided; (f) the identity of the lead analyst and the person primarily responsible for approving the rating is clearly stated in it; and (g), in the case of a rating outlook, the timeframe during which a change in the rating is expected is clear.

To elaborate the abovementioned requirements, CRAs must inform the rated entities in due time before releasing a rating and provide for them an opportunity to point out any factual errors in the rating procedure. In any case, credit ratings and all information relating to them are treated as inside information until the rating is disclosed publicly. This means that such information is protected by the duty of confidentiality and is accessible only by a prescribed list of persons.

Furthermore, the explanation accompanying the disclosure of rating methodologies, models and key rating assumptions should provide sufficient insight on the parameters, limits and uncertainties of the methodologies used, along with simulations of stress scenarios. In general, when a CRA publishes a rating, it must also outline the limitations of this rating, which can derive either from the lack of availability of high quality information or from the lack of historical data concerning the rated entity/instrument. As a result, CRAs are incentivized to refrain from issuing or even withdraw ratings that are either based on inadequate background data or concern financial instruments so complex in structure that may raise worries for the reliability of the rating.

[210] Ibid., Article 8 paragraph 4

[211] Ibid., Article 10 paragraph 2 and Section D of Annex I

As one might expect, there are specific rules with regard to the presentation of ratings on structured finance instruments and sovereign ratings. Firstly, the rating categories attributed to structured finance instruments should be distinguishable from the categories used in any other ratings, by adding an extra symbol. Furthermore, ratings of structured finance instruments should also include information about loss and cash-flow analysis, as well as information on the assessment of the due diligence processes at the level of the underlying assets and whether this assessment was undertaken by the same CRA or by a third party.

Secondly, sovereign ratings must now be accompanied with a publicly available thorough research report explaining the background data, the assumptions, and the limits and uncertainties that have been taken under consideration for issuing the rating. The same goes for updates on sovereign ratings; the research report must at least include an evaluation of the changes to the quantitative and qualitative assumptions of the rating and a description of the importance of each factor of the country's economy (per capita income, GDP growth, inflation, debt etc) as well as of the risks and limitations related to the change. Moreover, sovereign ratings, which can only be published after the close of business hours of regulated markets, should not contain any recommendations to the rated entities. Besides, all unsolicited ratings must be identified as such and a distinguishable color is to be used in rating categories to signify whether the rated entity or a related third party participated in the rating process by giving the CRA access to relevant internal documents and data.

Finally, CRA Regulation clarifies that the regulatory system set forth is aimed at supervising the activities of CRAs and should by no means be interpreted as granting regulatory powers to them. Therefore, a CRA should never exploit the name of ESMA or of competent authorities in such a way to suggest that its business and credit ratings are approved or endorsed by the regulatory authorities.

2. The European Rating Platform

A significant innovation introduced with the CRA III is the establishment of the "European rating platform" – a website run by ESMA which will serve as a central repository of information[212]. ESMA is to publish all the information that registered and certified CRAs disclose, so that they are easily accessible to the public. Such information that needs to be disclosed covers a wide range of subjects such as: (a) historical performance data of the credit ratings; (b) the exact date and time when new ratings are expected to be issued; (c) the type of each rating or rating-related action; and, of course, (d) the credit ratings themselves. However, credit ratings that are distributed to subscribers for a fee will not be published on the European rating platform.

3. Specific Disclosure Requirements

The disclosure requirements are further divided in general and periodic ones. General disclosures[213] include information with regard to: the CRA's status under the Regulation; actual and potential conflicts of interest; the ancillary services it provides; the policy adopted concerning the publication of ratings; an overview of the compensation arrangements; the methodologies, models and key rating assumptions used in its ratings; and its code of conduct.

---

[212] Ibid., Article 11a

[213] Ibid., Annex I Section E Part I

Periodic disclosures[214], on the other hand, include information with regard to: the historical default rates of the CRA's rating categories (published every six months); the fees charged to each client for rating and/or ancillary services; the CRA's pricing policy; a list of the clients whose contribution to the growth rate of the CRA's revenue is more than 1,5 times higher than the growth rate of that CRA's total revenues; and a list of the issued ratings with a clear indication of the proportion of unsolicited ratings among them (all of which are to be published annually).

Finally, apart from the general and periodic disclosures, CRAs are mandated to disclose publicly a transparency report on an annual basis[215]. This report shall provide information on: the CRA's legal structure and ownership composition; the internal controls implemented to guarantee the quality of its ratings; the allocation of its staff to rating activities of the different asset classes[216] and to new rating methodologies; the policies in place for record-keeping purposes and for the rotation of analysts and managers; the review of the compliance department; the revenue of the CRA, including total turnover divided into fees from rating and ancillary services; and a governance statement[217].

VI. Surveillance of Credit Rating Activities

1. Registration of Credit Rating Agencies

To ensure sufficient surveillance of the credit rating activities, CRA I stipulates that any CRA that is a legal person established in the EU may apply for registration to the ESMA and such registration is to be effective across the EU once the relevant decision has taken effect[218]. On the one hand, all registered CRAs are demanded to comply at all times with the conditions for initial registration and, consequently, they must notify ESMA of any material changes to these conditions, including any opening or closing of a branch within the EU. Moreover, registered CRAs must notify ESMA of the intended material changes to their rating methodologies, models or key rating assumptions as well as of new proposed rating methodologies, models or key rating assumptions simultaneously with the publication of these changes or proposals.

ESMA, on the other hand, cannot impose requirements regarding registration other than the ones set forth by CRA I and is obliged to register the applicant CRA if the examination of the registration application leads to the conclusion that this CRA complies with the Regulation's provisions for the issuing of credit ratings, especially those concerning the use of ratings for regulatory purposes (Article 4) and the independence and avoidance of conflicts of interest (Article 6).

2. Application for Registration

The registration process is initiated with the submission of the application for registration to the ESMA[219]. The application for registration must include detailed information on the matters outlined in Annex II of the Regulation. First of all, the full name of the CRA and the address of the registered office in the EU, its legal status and the class or classes of credit ratings for which it is applying to be registered need to be clearly stated. Secondly, the name

---

[214] Ibid., Annex I Section E Part II

[215] Ibid., Article 12 and Annex I Section E Part III

[216] i.e. ratings considering corporate, structured finance and sovereign rated assets

[217] Within the meaning of Article 46a(1) of Council Directive 78/660/EEC.

[218] Regulation 1060/2009, Article 14

[219] Ibid., Article 15

and contact details of an appointed contact person and of the compliance officer must be included in the application. Thirdly, information with regard to the CRA's ownership structure and whether it owns any subsidiaries or is part of a group of CRAs is required. Fourthly, the application must provide information on the CRA's organizational structure as well as information on corporate governance, such as a description of the methodologies used to issue and review ratings, and the policies implemented to identify, manage and disclose conflicts of interest. Moreover, information on the staffing of the CRA, especially with regard to its compensation and evaluation arrangements and to the rating analysts employed, has to be included. In addition, the applicant CRA must declare information on the financial resources dispensed for credit rating activities and whether it intends to provide services other than credit ratings. Finally, the application must also contain information and documents relating to the expected use of the endorsement regime and to the expected outsourcing arrangements, as well as the program of operations of the CRA – including indications of where the main business activities will take place, branches to be established, and an outline of the type of business anticipated.

The application for registration concerning a group of CRAs is submitted by one of the members, which the other members have appointed to do on their behalf. The mandated CRA is responsible for providing the information on the abovementioned matters for each member of the group. ESMA checks whether the application is complete within twenty working days of receiving it and, in case it needs to be completed with additional information, ESMA sets the relevant deadline for the CRA to provide such information. Once the application is assessed as complete, ESMA notifies the applicant accordingly.

3. Examination of the Application for Registration

Within forty-five working days, or fifty-five in case of a group of CRAs, of the notification that an application for registration is complete, ESMA examines the application with regard to the CRA's compliance with the conditions set out in the Regulation[220]. The examination period may be extended by fifteen working days, especially if the applicant CRA envisages endorsing credit ratings or using outsourcing, or requests exemption from compliance in accordance with Article 6(3). Nevertheless, ESMA is bound to adopt a decision to register or refuse registration upon expiration of these deadlines, which means either within forty-five working days (fifty-five in case of a group of CRAs) of the notification that the application is complete or within sixty working days (seventy in case of a group of CRAs) thereof, if the examination period is extended. The decision takes effect on the fifth working day following its adoption. ESMA needs to provide full reasons in all of its decisions concerning the registration of CRAs, especially when deciding the refusal or withdrawing of registration.

ESMA notifies the concerned CRA of the decision to register, refuse or withdraw registration within five working days of its adoption and updates accordingly the list of registered CRAs that is published on its website within the same deadline[221]. Furthermore, ESMA communicates these decisions to the Commission, EBA, EIOPA, the competent authorities and the sectoral competent authorities. Finally, the Commission publishes the list of registered CRAs in the Official Journal of the European Union within thirty days following any update.

---

[220] Ibid., Articles 16 and 17

[221] Ibid., Article 18

ESMA's necessary expenditure relating to the registration, certification and supervision of CRAs and the reimbursement of any costs that the competent authorities may incur carrying out work pursuant to their tasks under the CRA Regulation, in particular as a result of delegated tasks, are to be financed by fees charged to the CRAs[222]. The fees should be sufficient to provide for all administrative costs and at the same time proportionate to the turnover of each of the CRAs charged. The Commission is stipulated to adopt a regulation on fees by means of a delegated act[223], determining the type of fees and the matters for which fees are due, the amount of the fees, the way in which they are to be paid and the way in which ESMA is to reimburse competent authorities. ESMA shall charge the fees in accordance with Regulation 1060/2009 and the Commission's Regulation.

4. Withdrawal of Registration

According to Article 20 of Regulation 1060/2009, ESMA has the power to withdraw the registration of a CRA for certain reasons. Consequently, if a CRA: (a) expressly renounces the registration or has provided no credit ratings for the preceding six months; (b) obtained the registration by making false statements or by any other irregular means; or (c) no longer meets the conditions under which it was registered, then its registration may be withdrawn. The decision on the withdrawal of registration takes immediate effect throughout the EU.

Although ESMA can ascertain the fulfillment of any of the above conditions at any time, the competent authority of a Member State in which credit ratings issued by the CRA concerned are used may request that ESMA examine whether one of the conditions for withdrawal has been met, if the competent authority has reason to believe so. If, following such a request, ESMA finally decides not to withdraw the registration; it must provide full reasons in its decision.

VII. Supervision of Credit Rating Agencies by ESMA

1. ESMA as Supervisor of the Credit Rating Agencies

In the new regulatory system established by CRA II, ESMA is appointed as supervisor of CRAs, with the task to ensure that the Regulation is applied[224]; along with the sectoral competent authorities which are responsible for the supervision and enforcement of Articles 4(1), 5a and 8b-d in accordance with the relevant sectoral legislation[225]. In order for these obligations to be fulfilled, competent authorities, on the one hand, must be adequately staffed with regard to capacity and expertise[226], while ESMA, on the other hand, is stipulated to adopt guidelines on the cooperation between ESMA, the competent authorities and the sectoral competent authorities, including the procedures and detailed conditions relating to the delegation of tasks. Moreover, ESMA is mandated to issue guidelines on the application of the endorsement regime under Article 4(3) in cooperation with EBA and EIOPA.

In addition to the guidelines mentioned above, ESMA is required to develop draft regulatory technical standards to specify: (a) the information to be provided by CRAs in the registration applications; (b) the information that CRAs must provide for the certification application and for the assessment of any CRA's systemic importance to the financial stability or integrity of

[222] Ibid., Article 19
[223] Article 38a is the legal basis for delegated acts, which are subject to the conditions of Articles 38b-c.
[224] Regulation 1060/2009, Article 21
[225] Ibid., Article 25a
[226] Ibid., Article 22

financial markets; (c) the appropriate presentation of the information that CRAs shall disclose in accordance with Articles 11a(1) and 11(2) and point 1 of Part II of Section E of Annex I; (d) the assessment of compliance of credit rating methodologies; and (e) the content and format of ratings data periodic reporting to be requested from registered and certified CRAs for the purpose of ongoing supervision. These draft regulatory technical standards are to be submitted to the Commission, to which power is delegated to adopt them[227].

ESMA, the Commission or any public authorities of a Member State are in general prohibited from interfering with the content of credit ratings or methodologies when carrying out their duties[228]. Another restriction set by CRA II is that the powers conferred to ESMA cannot be used to require the disclosure of information or documents which are subject to legal privilege [229]. However, ESMA, in the exercise of its ongoing supervision of CRAs, examines regularly the compliance with methodology requirements[230], i.e. that CRAs use rigorous, systematic and continuous rating methodologies which are subject to validation[231]. More specifically, ESMA is responsible for verifying the execution of back-testing by CRAs, analyzing the results of that back-testing, and ensuring that CRAs have processes in place to take into account the results of the back-testing in their rating methodologies.

ESMA cooperates with EBA and EIOPA in performing its tasks. Besides, ESMA is bound to take the consultation of EBA and EIOPA before issuing or updating guidelines and submitting draft regulatory standards, especially in order to determine what information is necessary for assessing a CRA's systemic importance to the financial stability or integrity of financial markets.

Not surprisingly, along with power comes responsibility. Therefore, ESMA is prescribed to publish annual reports on the application of the Regulation, in which an assessment of the implementation of Annex I by the registered CRAs and an assessment of the application of the endorsement mechanism need to be included. Furthermore, ESMA has the obligation to present to the European Parliament, the Council and the Commission annual reports on supervisory measures taken and penalties imposed by it under the Regulation 1060/2009, including fines and periodic penalty payments.

2. Requests for Information

With the aim to strengthen the supervision of CRAs, Article 23b of CRA I states that ESMA may by simple request or by decision require: CRAs; persons involved in credit rating activities; rated entities and related third parties; third parties to whom operational functions or activities of the CRAs have been outsourced; and persons otherwise closely and substantially related or connected to CRAs or rating activities to provide all information that is necessary in order to carry out its duties under the CRA Regulation. Consequently, these persons or their representatives and, in the case of legal persons, the persons authorized to represent them by law or by their constitution, are ordained to supply the information requested. Lawyers duly authorized to act may supply the information on behalf of their clients, but the latter remain fully responsible if the information supplied is incomplete,

[227] In accordance with the procedure laid down in Articles 10 to 14 of Regulation 1095/2010.
[228] Regulation 1060/2009, Article 23
[229] Ibid., Article 23a
[230] Ibid., Article 22a
[231] Ibid., Article 8(3)

incorrect or misleading. Finally, the competent authority of the Member State where the persons concerned by the request for information are domiciled or established is notified by ESMA of the relevant simple request or decision.

When sending a simple request for information or when requiring the supply of information by decision, ESMA must refer to Article 23b as the legal basis for the request. Also, the purpose of the request must be stated and the required information must be specified. ESMA sets the deadline within which the persons concerned must comply and provide the information. ESMA must also indicate the fine provided for incorrect or misleading answers according to Article 36a, in conjunction with point 7 of Section II of Annex III. In the case of simple requests, ESMA informs the persons concerned that there is no obligation to provide the information but that any reply must not be incorrect or misleading. In the case of decisions requiring information, ESMA indicates the periodic penalty payments provided for incomplete production of the required information according to Article 36b and informs the persons concerned of the right to appeal the decision before the Board of Appeal and to have the decision reviewed by the Court of Justice of the European Union in accordance with Articles 60 and 61 of Regulation 1095/2010.

3. General Investigations

In addition to the power of requesting information, the power to conduct all necessary investigations of the persons mentioned above is conferred to ESMA, so that it can carry out its duties effectively[232]. To that end, the officials of ESMA and other persons authorized by it are empowered to: (a) examine any records, data, procedures and any other material relevant to the execution of its tasks irrespective of the medium on which they are stored; (b) take or obtain certified copies of or extracts from such records, data, procedures and other material; (c) summon and ask any person concerned or their representatives or staff for oral or written explanations on facts or documents related to the subject matter and purpose of the inspection and to record the answers; (d) interview any other natural or legal person who consents to be interviewed for the purpose of collecting information relating to the subject matter of an investigation; and (e) request records of telephone and data traffic.

Consequently, the persons concerned are required to submit to investigations launched on the basis of a decision of ESMA, in which the subject matter and purpose of the investigation, the periodic penalty payments provided for in Article 36b, the legal remedies available under Regulation 1095/2010 and the right to have the decision reviewed by the Court of Justice of the European Union are specified. The officials of and other persons authorized by ESMA to carry out the investigation can exercise their powers upon production of a written authorization, in which the subject matter and purpose of the investigation are specified. That authorization must also indicate the periodic penalty payments provided for in Article 36b, in case the production of the required records etc or the answers to questions asked are not provided or are incomplete, as well as the fines provided for in Article 36a, in conjunction with point 8 of Section II of Annex III, in case the answers of the persons who are being investigated are incorrect or misleading.

ESMA informs the competent authority of the Member State where the investigation will take place of the relevant decision and of the identity of the authorized persons in due time. ESMA may also request of the competent authority that its officials assist those authorized persons in

[232] Ibid., Article 23c

carrying out their duties. Besides, officials of the competent authority can also attend the investigations upon request.

Finally, ESMA applies for authorization from a judicial authority if a request for records of telephone or data traffic requires such authorization according to national rules. The authorization may also be applied for as a precautionary measure. Upon examining the request, the national judicial authority checks the authenticity of the decision of ESMA and controls that the coercive measures envisaged are neither arbitrary nor excessive with regard to the subject matter of the investigations. To decide upon the proportionality of the coercive measures, the national judicial authority may ask ESMA for detailed explanations. Such explanations may include the grounds ESMA has for suspecting that an infringement of the Regulation 1060/2009 has taken place, as well as the seriousness of the suspected infringement and the nature of the involvement of the person subject to the coercive measures. However, the national judicial authority cannot review the necessity for the investigation nor demand that it be provided with the information on ESMA's file. Besides, the Court of Justice of the European Union is exclusively competent for reviewing the lawfulness of ESMA's decisions following the procedure set out in Regulation 1095/2010.

4. On-site Inspections

Apart from the general investigations described above, ESMA, when performing its supervisory duties, also has the power to conduct all necessary on-site inspections[233] at the business premises of the legal persons referred to in Article 23b(1). On-site inspections may be carried out without prior announcement, if this is essential for the proper conduct and efficiency of the inspection. The persons concerned are required to submit to on-site inspections ordered by decision of ESMA, in which the details described above with regard to general investigations along with the date on which the inspection is to begin are specified.

ESMA takes such decisions after consulting the competent authority of the Member State where the inspection will take place. Besides, officials of the competent authority as well as persons authorized or appointed by it may be requested by ESMA to actively assist in the conduct of the inspection or may attend the inspection upon request. ESMA may also require competent authorities to carry out specific investigatory tasks and on-site inspections on its behalf.

In addition to the powers described above with regard to general investigations, the persons authorized by ESMA to conduct an on-site inspection have the power to enter any business premises of the legal persons subject to an investigation decision. They also have the power to seal any business premises and books or records for the period of, and to the extent necessary for, the inspection. When officials of the competent authority of the Member State concerned are required to assist in the investigation, they enjoy the same powers afforded to ESMA’s officials.

The persons authorized by ESMA to conduct an on-site inspection can exercise their powers upon production of a written authorization, which specifies, mutatis mutandis, the matters outlined above with regard to general investigations. If a person opposes an inspection, the competent authority of the Member State where the inspection is carried out must support ESMA’s officials by providing the necessary assistance so as to enable them to conduct the

[233] Ibid., Article 23d

inspection ordered. Such assistance may include requesting aid of the police or of an equivalent enforcement authority.

ESMA applies for authorization from a judicial authority if the on-site inspection or the assistance to it requires such authorization according to national rules. The authorization may also be applied for as a precautionary measure. Upon examining the request, the national judicial authority applies the same criteria and is restricted by the same rules as to when examining a request for investigation. Like investigation decisions, inspection decisions taken by ESMA are subject to review only by the Court of Justice of the European Union.

5. Procedure for Taking Supervisory Measures and Imposing Fines

If ESMA, upon carrying out its supervisory duties, finds that there are serious indications of the possible existence of facts constituting one or more of the infringements listed in Annex III of Regulation 1060/2009, it appoints an independent officer within ESMA to investigate the matter[234]. This investigating officer cannot be or have been involved in the supervision or registration process of the CRA concerned and performs his functions independently from ESMA's Board of Supervisors. In order to accomplish their tasks, the investigating officer may exercise the powers to require information and to conduct investigations and on-site inspections; these powers do not extend to information and documents subject to legal privilege. Moreover, the investigating officer has access to all documents and information gathered by ESMA in its supervisory activities.

Generally, the rights of defence of the persons subject to investigations must be fully respected at all times. More specifically, when examining the alleged infringements, the officer should take into account any comments submitted by the persons concerned, who must be given the opportunity to be heard on the relevant matters upon completion of the investigation and before submission of the file to ESMA's Board of Supervisors. Investigating officers should not base their findings on facts on which the persons subject to investigation did not have the opportunity to comment.

In the end, the investigating officer submits a complete file with their findings to ESMA's Board of Supervisors and notifies the persons concerned accordingly. At this point, the officer's tasks are completed and they are prohibited from participating in the deliberations of ESMA's Board of Supervisors or in any other way intervening in the decision-making process. The persons concerned are entitled to have access to the file, subject to the legitimate interest of other persons in the protection of their business secrets. The right of access to the file does not extend to confidential information affecting third parties.

Then, based on the file containing the investigating officer's findings and, when requested by the persons concerned, after having heard the response of the persons subject to investigation, ESMA's Board of Supervisors decides whether one or more infringements has been committed. In such case, the Board of Supervisors takes a supervisory measure in accordance with Article 24 and imposes a fine in accordance with Article 36a.

Also, if ESMA finds that there are indications of the possible existence of facts liable to constitute criminal offences, it must refer to the relevant national authorities for criminal prosecution. Besides, it must refrain from imposing fines or periodic penalty payments where

---

[234] Ibid., Article 23e

a prior acquittal or conviction arising from identical facts, or from facts which are substantially the same, has acquired the force of *res judicata* as the result of criminal proceedings under national law.

6. Supervisory Measures by ESMA

ESMA's Board of Supervisors, following the examination of the file submitted to it by the investigating officer, decides whether the CRA concerned has indeed committed an infringement and, in such case, it is stipulated to take one or more of the following measures to: (a) withdraw the registration of the CRA; (b) temporarily prohibit the CRA from issuing credit ratings with effect throughout the EU, until the infringement has been brought to an end; (c) suspend the use, for regulatory purposes, of the credit ratings issued by the CRA with effect throughout the EU, until the infringement has been brought to an end; (d) require the CRA to bring the infringement to an end; (e) issue public notices[235].

The nature and seriousness of the detected infringement are taken into account to determine which measure or measures will be implemented each time. Regulation 1060/2009 provides for the following criteria to be applied in this evaluation: (a) the duration and frequency of the infringement; (b) whether the infringement has revealed serious or systemic weaknesses in the undertaking's procedures or in its management systems or internal controls; (c) whether financial crime was facilitated, occasioned or otherwise attributable to the infringement; and (d) whether the infringement has been committed intentionally or negligently.

When the measures of withdrawal of registration or suspension of the use of the CRA's ratings for regulatory purposes are decided, these ratings may, however, continue to be used for regulatory purposes during a transitional period. The transitional period starts on the date ESMA's decision is made public and its maximum duration is either ten working days, if there are credit ratings of the same financial instrument or entity issued by other registered CRAs, or three months, if there are no such credit ratings of the same financial instrument or entity. This period may be extended by three months in exceptional circumstances relating to the potential for market disruption or financial instability; EBA and EIOPA have the right to request such extension. Besides, ESMA's Board of Supervisors must notify EBA and EIOPA before deciding on the measures referred in points (a), (b) and (c).

ESMA's Board of Supervisors notifies, without undue delay, the decision to impose supervisory measures to the CRA concerned and further communicates any such decision to the competent authorities and the sectoral competent authorities, the Commission, EBA and EIOPA. Within ten working days from the date the decision was adopted, it is publicized on ESMA's website. Along with the decision to take supervisory measures, ESMA should also make public the right for the CRA concerned to appeal the decision and whether such an appeal has been lodged. It should also be clarified to the public that such an appeal does not have suspensive effect, although it is possible for the Board of Appeal to suspend the application of the contested decision[236].

The rights of defence for the persons subject to the proceedings outlined above are fully protected by the law[237]. They have the right to access ESMA's file, subject to the same

[235] Ibid, Article 24

[236] In accordance to Article 60(3) of Regulation 1095/2010

[237] Regulation 1060/2009, Article 25

restrictions mentioned in the analysis of the investigation procedure. They also have, mutatis mutandis, the right to be heard and comment on ESMA's findings. However, this right can be abated when urgent action is needed in order to prevent significant and imminent damage to the financial system. In such a case ESMA's Board of Supervisors adopts an interim decision and gives the persons concerned the opportunity to be heard as soon as possible afterwards.

7. Penalties, Fines and Periodic Penalty Payments

7.1. Penalties

According to Article 36 of the CRA Regulation, the penalties applicable to infringements of Article 4(1) with regard to the use of ratings for regulatory purposes are for the Member States to define. The penalties provided for must be effective, proportionate and dissuasive and Member States are obliged to ensure that they are indeed implemented. Member States must also ensure that the sectoral competent authority disclose to the public every penalty that has been imposed, unless such disclosure would seriously jeopardize the financial markets or cause disproportionate damage to the parties involved.

7.2. Fines

ESMA's Board of Supervisors, along with the decision to impose one or more supervisory measures, adopts a decision to impose a fine, if it finds that a CRA has either intentionally or negligently committed one of the infringements listed in Annex III of the Regulation[238]. An infringement is considered to have been committed intentionally if ESMA becomes aware of objective factors which demonstrate that the CRA or its senior management acted deliberately to commit the infringement.

Generally speaking, the fines may range between EUR 10.000 and EUR 750.000. More specifically, depending on which infringement is committed in accordance with Article 36a(2), the basic amount of the fines is included within the following limits: EUR 10.000-50.000, EUR 25.000-75.000, EUR 40.000-100.000, EUR 50.000-150.000, EUR 90.000-200.000, EUR 100.000-200.000, EUR 150.000-300.000, EUR 300.000-450.000, and EUR 500.000-750.000. In order to decide whether the basic amount of the fine imposed should be set at the lower, the middle or the higher end of the above limits, ESMA takes into consideration the annual turnover in the preceding business year of the CRA concerned. Consequently, the basic amount is at the lower end of the limit for the CRAs whose annual turnover is below EUR 10 million, the middle of the limit for the CRAs whose annual turnover is between EUR 10 and 50 million and, last, the higher end of the limit for the CRAs whose annual turnover is higher than EUR 50 million.

Furthermore, the basic amounts of the fines may be adjusted by taking into account aggravating or mitigating factors in accordance with the relevant coefficients set out in Annex IV. Aggravating factors, on the one hand, include: the repeated or prolonged commitment of the infringement; systemic weaknesses of the CRA's organization and internal controls; the negative impact caused on the quality of the ratings; whether the infringement was committed intentionally; the lack of remedial action since the breach was identified; and the fact that CRA's management did not cooperate with ESMA in the investigations. Mitigating factors, on the other hand, include: the fact that the infringement was committed for fewer than ten working days; whether all necessary measures were implemented by the CRA's senior management to prevent the breach; whether the CRA brought the matter to ESMA's attention

[238] Ibid., Article 36a

quickly and effectively; and if the CRA has voluntarily taken measures to ensure that similar infringement will not be committed again. The relevant coefficients are applied one by one to the basic amount. In the cases where more than one aggravating or mitigating coefficient is applicable, the difference between the basic amount and the amount resulting from the application of each individual coefficient is added to or subtracted from the basic amount, depending on the type of coefficients applied[239].

Finally, if one act or omission of a CRA constitutes more than one infringement, only the higher fine calculated and related to one of those infringements applies. Anyway, the final amount of the imposed fine cannot exceed 20% of the annual turnover of the CRA concerned in the preceding business year. Meanwhile, if the CRA has directly or indirectly benefitted financially from the infringement, the fine is at least equal to that financial benefit.

7.3. Periodic Penalty Payments

A periodic penalty payment can be imposed by decision of ESMA's Board of Supervisors in order to compel either a CRA to put an end to an infringement in accordance with a decision taken pursuant to point (d) of Article 24(1) or a person referred to in Article 23b(1) to supply complete information which has been required by a decision pursuant to Article 23b, to submit to an investigation and in particular to produce complete records, data, procedures or any other material required and to complete and correct other information provided in an investigation launched by a decision taken pursuant to Article 23c, or to submit to an on-site inspection ordered by a decision taken pursuant to Article 23d[240].

Periodic penalty payments are imposed on a daily basis until the CRA or the person concerned complies with the relevant decision, but for a period not exceeding six months since the notification of ESMA's decision. Moreover, they must be effective and proportionate. More specifically, the amount of a periodic penalty payment imposed on a CRA is 3% of its daily turnover in the preceding business year, while that of penalties imposed on natural persons is 2% of their average daily income in the preceding calendar year.

7.4. Disclosure and Enforcement of Fines and Periodic Penalty Payments

The persons subject to the proceedings leading to the imposition of a fine and/or a periodic penalty payment enjoy, mutatis mutandis, full protection with regard to their rights of defence, especially the right to be heard and to have access to the relevant files[241].

Fines and periodic penalty payments imposed pursuant to Articles 36a and 36b are of an administrative nature and the amounts of them are allocated to the general budget of the EU[242]. ESMA discloses to the public all fines and periodic penalty payments that have been imposed, unless such disclosure might seriously jeopardize the financial markets or cause disproportionate damage to the parties involved.

Fines and periodic penalty payments are also enforceable, in accordance with the rules of civil procedure in force in the Member Sate where enforcement is carried out. The order for its

[239] Added when aggravating coefficients are applied; subtracted when mitigating ones are applied.
[240] Regulation 1060/2009, Article 36b
[241] Ibid., Article 36c
[242] Ibid., Article 36d

enforcement is appended to ESMA's decision without other formality than verification of its authenticity by the authority designated for this purpose by the government of each Member State. Once the authenticity of ESMA's decision is verified, the party concerned can proceed to enforcement in accordance with the national law, by bringing the matter directly before the competent body. Although the courts of the Member State concerned have jurisdiction over complaints that enforcement is being carried out in an irregular manner, ESMA's decisions can be suspended only by a decision of the Court of Justice of the EU. Besides, the Court of Justice of the EU has unlimited jurisdiction to review decisions whereby ESMA has imposed a fine or a periodic penalty payment; thus it may annul, reduce or increase the fine or periodic penalty payment imposed[243].

VIII. Civil Liability of Credit Rating Agencies

Despite the fact that civil liability of CRAs is generally governed by the applicable national law as determined by the relevant rules of private international law, CRA Regulation provides for the minimum standards of it; especially for the right of redress. Therefore, Article 35a of Regulation 1060/2009 now states that investors and issuers may claim damages from a CRA on condition that: (a) the latter has committed, intentionally or with gross negligence, any of the infringements listed in Annex III; (b) such infringement had an impact on a credit rating; and (c) the investor or issuer concerned has suffered damages due to that infringement.

Moreover, an investor may claim damages only if they establish that they had reasonably relied, in accordance with Article 5a(1) or otherwise with due care, on the relevant rating for a decision to invest into, hold onto or divest from a financial instrument covered by that rating. An issuer, on the other hand, may claim damages only if they establish that they or their financial instruments are covered by the relevant rating and that the infringement was not caused by misleading and inaccurate information provided by the issuer to the CRA either directly or through information publicly available. The responsibility to present accurate and detailed information indicating that the CRA has committed an infringement and that this infringement had an impact on the credit rating issued lies with the investor or issuer claiming damages. The assessment of what constitutes accurate and detailed information is carried out by the competent national court, which should take into consideration that the investor or issuer may not have access to information which is purely within the sphere of the CRA.

Finally, according to CRA III, the civil liability of CRAs can only be limited in advance where that limitation is: (a) reasonable and proportionate; and (b) allowed by the applicable national law. Limitations that do not comply with these conditions and exclusions of civil liability are deprived of any legal effect. Besides, further civil liability claims that are not provided for in the Regulation but are in accordance with national law can always be brought in court.

IX. Towards Reducing the Reliance on Credit Ratings

CRA III includes provisions with the intent of reducing excessive reliance on credit ratings in EU legislation and incentivizing financial institutions to establish internal methods for assessing the creditworthiness of their investments. More specifically, the Commission is stipulated to progressively review whether references to credit ratings in Union law trigger or have the potential to trigger sole or mechanistic reliance on credit ratings by the financial supervisors, the financial institutions subject to regulation or other financial market

[243] Ibid., Article 36e

participants[244]. This ongoing review is to be carried out towards the goal of deleting all references to CRA ratings in EU law for regulatory purposes by January 1st, 2020, on condition that appropriate alternatives to credit risk assessment have been identified and implemented.

Furthermore, EBA, ESMA, and EIOPA are mandated to remove any references to CRA ratings from their guidelines, recommendations and draft technical standards, and to avoid such references in the future[245]. The European Systemic Risk Board (ESRB) is demanded to avoid references to CRA ratings in its warnings and recommendations, too.

Finally, credit institutions, investment firms, insurance and reinsurance undertakings, institutions for occupational retirement provision, management companies, alternative investments fund managers and central counterparties are required to make their own credit risk assessment rather than mechanistically rely on CRA ratings for assessing the creditworthiness of an entity or financial instrument[246]. To ensure compliance with this requirement, the sectoral competent authorities in charge of supervising those financial institutions are expected to monitor the adequacy of the internal credit risk assessment processes adopted. They should also encourage the supervised entities, taking into account the nature, scale and complexity of each one's activities, to mitigate the impact of references to CRA ratings in line with specific sectoral legislation.

[244] Ibid., Article 5c
[245] Ibid., Article 5b
[246] Ibid., Article 5a

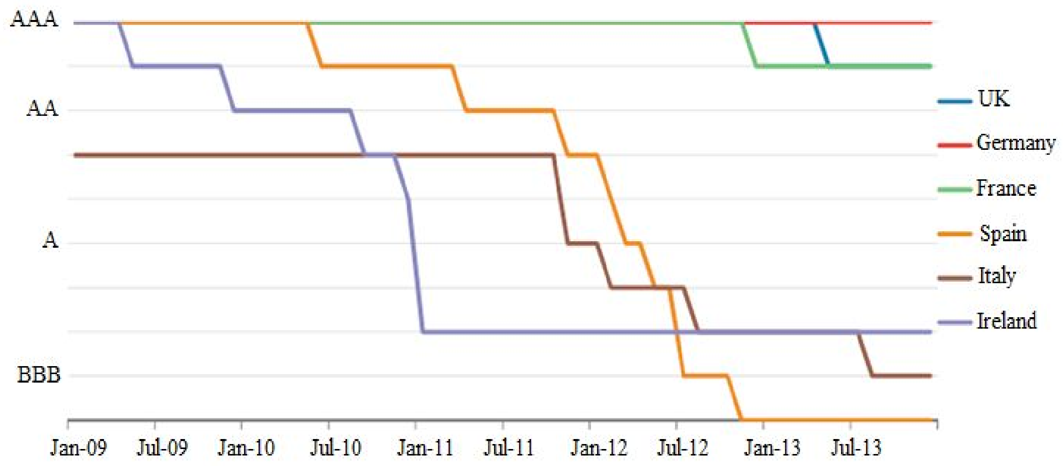
Table 7: List of Registered and Certified CRAs in accordance with Regulation 1060/2009, as of October 27th 2015 (published by ESMA)

Name of CRA	Country of residence	Status	Effective date
Euler Hermes Rating GmbH	Germany	Registered	16 November 2010
Japan Credit Rating Agency Ltd	Japan	Certified	6 January 2011
Feri EuroRating Services AG	Germany	Registered	14 April 2011
BCRA-Credit Rating Agency AD	Bulgaria	Registered	6 April 2011
Creditreform Rating AG	Germany	Registered	18 May 2011
Scope Ratings AG (previously PSR Rating GmbH)	Germany	Registered	24 May 2011
ICAP Group SA	Greece	Registered	7 July 2011
GBB-Rating Gesellschaft für Bonitätsbeurteilung GmbH	Germany	Registered	28 July 2011
ASSEKURATA Assekuranz Rating-Agentur GmbH	Germany	Registered	18 August 2011
ARC Ratings, S.A. (former Companhia Portuguesa de Rating, S.A)	Portugal	Registered	26 August 2011
AM Best Europe-Rating Services Ltd. (AMBERS)	UK	Registered	8 September 2011
DBRS Ratings Limited	UK	Registered	31 October 2011
Fitch France S.A.S.	France	Registered	31 October 2011
Fitch Deutschland GmbH	Germany	Registered	31 October 2011
Fitch Italia S.p.A.	Italy	Registered	31 October 2011
Fitch Polska S.A.	Poland	Registered	31 October 2011
Fitch Ratings España S.A.U.	Spain	Registered	31 October 2011
Fitch Ratings Limited	UK	Registered	31 October 2011
Fitch Ratings CIS Limited	UK	Registered	31 October 2011
Moody’s Investors Service Cyprus Ltd	Cyprus	Registered	31 October 2011
Moody’s France S.A.S.	France	Registered	31 October 2011
Moody’s Deutschland GmbH	Germany	Registered	31 October 2011
Moody’s Italia S.r.l.	Italy	Registered	31 October 2011

Moody's Investors Service España S.A.	Spain	Registered	31 October 2011
Moody's Investors Service Ltd	UK	Registered	31 October 2011
Standard & Poor's Credit Market Services France S.A.S.	France	Registered	31 October 2011
Standard & Poor's Credit Market Services Italy S.r.l.	Italy	Registered	31 October 2011
Standard & Poor's Credit Market Services Europe Limited	UK	Registered	31 October 2011
CRIF S.p.A.	Italy	Registered	22 December 2011
Capital Intelligence (Cyprus) Ltd	Cyprus	Registered	8 May 2012
European Rating Agency, a.s.	Slovakia	Registered	30 July 2012
Axesor SA	Spain	Registered	1 October 2012
Cerved Rating Agency S.p.A. (former CERVED Group S.p.A.)	Italy	Registered	20 December 2012
Kroll Bond Rating Agency	USA	Certified	20 March 2013
The Economist Intelligence Unit Ltd	UK	Registered	3 June 2013
Dagong Europe Credit Rating Srl (Dagong Europe)	Italy	Registered	13 June 2013
Spread Research	France	Registered	1 July 2013
EuroRating Sp. z o.o.	Poland	Registered	7 May 2014
HR Ratings de México, S.A. de C.V. (HR Ratings)	Mexico	Certified	7 November 2014
Moody's Investors Service EMEA Ltd	UK	Registered	24 November 2014
Egan-Jones Ratings Co. (EJR)	USA	Certified	12 December 2014
modeFinance S.r.l.	IT	Registered	10 July 2015
INC Rating Sp. z o.o.	Poland	Registered	27 October 2015

Table 8: Selected European Sovereign Composite* Ratings[247]

[247] Becker/Milbourn, p. 31



*Composite ratings are calculated by combining the ratings of Fitch's, S&P and Moody's and taking the second highest rating.

Section D: Concluding Remarks

Since the beginning of the global financial crisis of 2007-2008, the search for its causes has been rigorous on both sides of the Atlantic. According to the findings, CRAs certainly bear some responsibility. This is acknowledged by both policymakers and market participants. It soon became clear that, given the depth of the crisis, CRAs would not be able to satisfy policymakers by eliminating flaws in their rating methods and improving corporate governance. Although the CRAs were more or less unregulated before the outbreak of the financial crisis, after the crisis started, politicians became increasingly vocal in demanding regulation. Initially, these demands were confined to a more binding form of self-regulation. But as the crisis progressed, the calls for state regulation on the basis of supervision grew ever louder.

On a global level, IOSCO was historically the first international body to underline the growing importance of credit ratings in modern financial markets and to attempt to regulate the function of CRAs by highlighting the main concerns arising from the conflicts of interest caused by the issuer-pays business model. Apparently, the suggestions of this early regulatory effort were not enough to prevent the subprime crisis of 2007. Surely, the fact that intervention powers were never granted to IOSCO by national/regional regulating authorities characterizes the power of the IOSCO CRA Code, which is based on self-regulation and influence instead of legal enforcement[248]. Nevertheless, IOSCO is the forum where regulators from all over the world discuss on preliminary regulatory approaches which are meant to serve as model practices and guidelines. Therefore, the impact of the main principles of the IOSCO CRA Code is evident on regulatory legislations across the globe.

In addition to the IOSCO, the FSB appears to address the problem of CRAs focused on the impact their ratings have on market participants, rather than on the inherent conflicts of interest that threaten to undermine the quality and integrity of the ratings. To put it in other words, the function of CRAs was not an issue for FSB until after the financial crisis of 2007-2008, when ratings' power over markets was fully comprehended. As a result, the FSB Principles aim mainly to strip CRA ratings of any official "seal of approval" and substitute them with adequate internal credit assessment procedures. This results-centered approach is in accordance with FSB's role as coordinator, at the international level, of the work of national financial authorities and international standard setting bodies, and with its goal of developing and promoting effective policies in the interest of financial stability.

Legislators in the EU and the U.S. incorporated IOSCOS's and FSB's guidelines in the relevant regulations. Thus, mainly focused on symptoms of the crisis, they initially pursued traditional securities law strategies of disclosure and liability, as well as new corporate governance mandates to prompt the CRAs to generate accurate ratings, in the intent of avoiding informational failures in the future[249]. Although both the CRA Regulation and the Dodd-Frank Act prohibit supervisors (i.e. the ESMA and SEC respectively) from regulating the substance of credit ratings or the procedures and methodologies by which ratings are generated, the current CRA legislation is quite broad, stringent and detailed.

---

[248] Mastromanolis, p. 75

[249] McNamara, p. 749

As far as conflicts of interest are concerned, if the issuer-pays business model is the main cause of conflicts, one could argue that the most effective solution would consist of reverting to subscriber-paid ratings. However, that kind of total change is yet too difficult and controversial[250]. Consequently, neither the CRA Regulation nor the Dodd-Frank Act requires such a change on CRAs' business model. Nevertheless, both EU and U.S. regulators have called for various governmental bodies to undertake studies to analyze how to address the issue. Although these studies might eventually offer innovative solutions, the question of conflicts due to the issuer-pays model is still open.

Furthermore, extensive disclosure requirements are included in both the CRA Regulation and the Dodd-Frank Act, in the scope of guaranteeing the quality of the credit ratings. These provisions have a dual goal: on the one hand, to stimulate demand for disclosure of data related to underlying assets on the part of the investors and, on the other hand, to incentivize due diligence on the part of the CRAs. To the extent that the laws further increase the due diligence of CRAs, it needs to be seen whether this actually results in more distinguished and exact ratings, thereby signaling to investors more clearly the credit risks of a given financial instrument and the risks of relying on a credit rating as a means of financial advice[251].

With regard to civil liability of CRAs, European legislation provides for the minimal standard of investor protection under the CRA Regulation, while further claims can be brought to courts according to each Member State's national law. The Dodd-Frank Act, on the other hand, seeks for enhanced accountability in the rating industry, but, as courts will have to interpret the new legislation, the "state of mind" rule might actually have a limited scope. It remains unclear whether plaintiffs will be able to establish that CRAs knowingly or recklessly failed to conduct a reasonable investigation, or precisely how courts will apply this standard[252]. Besides, the repeal of Rule 436(g) proved to be a controversial issue. Despite its intent was to establish a regime where CRAs are subject to expert liability, the SEC's no-action letter still blocks effective implementation of the amendment. It remains unclear how this will be resolved.

With regard to supervision of the CRAs, the Dodd-Frank Act, on the one hand, provides for oversight similar to that of other gatekeepers; in the same time, it provides regulators with significant room for interpretation and implementation of the new rules. So, it remains to be seen to what extent and in what direction the SEC will use its enhanced regulatory powers and whether the Office of Credit Ratings will take full advantage of its regulatory authority. The CRA Regulation, on the other hand, provides for a strict supervisory system on the Union level and ESMA is granted extensive supervisory powers in order to safeguard CRAs' compliance with the new regulatory framework. Evidently, CRAs are subject to stricter supervision under EU law, as ESMA has the power to impose fines for infringements of the CRA Regulation and periodic penalty payments to ensure CRAs' compliance. Furthermore, the European regulation aims to include in its supervisory framework CRAs established outside the EU whose ratings are systemically important for the Union's financial markets and overall financial stability.

---

[250] Darbellay/Partnoy, pp. 15-16
[251] Amtenbrink/Heine, The Dovenschmidt Quarterly 2-15
[252] Darbellay/Partnoy, pp. 21-22

Not surprisingly, CRA Regulation has been criticized for reflecting a sort of "regulatory imperialism"[253]. Nevertheless, the European legislators' approach can be justified by the reality of the credit rating industry, which is dominated by the three American-based CRAs. Besides, CRA Regulation provides for incentives to increase competition. The obligation to use more than one CRA for the rating of structured finance instruments, as well as the obligation on parts of CRAs not to enter into contractual relationships with issuers for longer than four years, may result in a diversification of the market for credit ratings. However, excessive oversight usually brings along more bureaucracy and can possibly undermine competition in the rating industry by raising regulatory barriers to entry, which is exactly the opposite of the regulators' goal[254].

Regarding the withdrawal of rating-based regulation, the challenge is for global, European, and American regulators and institutional investors to find appropriate substitutes. Governmental agencies and market participants will have to work on providing the solutions that are most appropriate for their own needs. Credible alternatives and substitutes must be developed in order to reduce private reliance on ratings as well. Once regulatory reliance on ratings is eliminated, it remains to be seen whether CRAs significance for the financial markets will endure. Reducing overreliance on credit ratings is indeed a controversial issue in both European and American legislations, which seem to pursue a double strategy. On the one hand, the drafters of the CRA Regulation and the Dodd-Frank Act intended to reduce overreliance on ratings. On the other hand, by concentrating the regulatory reforms on CRAs, for example by establishing a stricter supervisory system of CRAs and, moreover, by introducing numerous measures geared towards increasing the quality and reliability of credit ratings, investors are not exactly discouraged from relying on ratings.

Apparently, the European and American responses to most of the issues are not radical. Legislators' avoidance of a more direct approach could be justified by several reasons[255]. Firstly, to directly regulate extremely technical problems in the rating methods through legislation would seem to involve mandating the substance of credit ratings. Secondly, the very nature of the credit rating process might be too complex and specialized for regulators – even expert ones like the EU Commission and the SEC employees – to govern effectively. Thirdly, the increased demand for credit ratings took place within the context of a regulatory system that was first established in the U.S. and consequently spread globally and required credit ratings for a broad range of financial activities. Given that CRAs in fact benefited from the flaws of the system rather than creating them, legislators appear to be stuck in a complicitous trap, for if CRAs were really guilty of fraud, then the regulatory architecture would have to be named as their primary accomplice[256].

Nevertheless, international, European and American policymakers tend to assess the recent reforms in terms of the regulation of CRAs as a success story for the "lessons learned" from the crisis[257]. Indeed, one could argue that by fixing the systemic failures, which were made evident due to the CRAs' role in the crisis, policymakers at least try to address the "wrongs" by attempting to impose a new liability and oversight regime and eliminating regulatory

---

[253] Mastromanolis, p. 98
[254] Darbellay/Partnoy, pp. 15-16
[255] McNamara, pp.746-748
[256] Mennillo/Roy, p. 4
[257] Ibid., p. 6

reliance on ratings[258]. However, it remains unclear how the removal of credit rating references from regulation will affect the markets and whether a healthy and competitive market for credit ratings will emerge. During this transition period, the three dominant CRAs will still enjoy a certain privilege in the rating business and more vigorous oversight and accountability measures could improve their performance[259].

The transitional nature of the legislation is more evident in the CRA Regulation, under which the EU Commission is required to report to the European Parliament and the European Council on various issues arising from the implementation of CRA III, including: (a) the appropriateness of the development of a European creditworthiness assessment for sovereign debt; (b) the steps taken regarding the removal of references to credit ratings which trigger or have the potential to trigger sole or mechanistic reliance on credit ratings, and alternative tools to enable investors to make their own credit risk assessments, with a view to deleting all references to credit ratings in EU law for regulatory purposes by January 1st, 2020; (c) whether the Joint Disclosure Requirements should be extended to any other financial credit products; (d) the availability of sufficient choice to comply with the rotation requirements; (e) whether various provisions such as those intended to avoid conflicts of interest have sufficiently mitigated such conflicts of interest; and (f) on the appropriateness and feasibility of supporting a European CRA for assessing the creditworthiness of the sovereign debt of Member States and/or a European credit rating foundation for all other credit ratings. The Dodd-Frank Act also calls for additional study or regulation.

To conclude with, the recent legislative reforms, like the majority of regulatory reforms undertaken in order to address crises in the financial sector, are somewhat backward-looking and should be regarded as the beginning, not the end, of the regulatory debate[260]. Thus, the future roadmap remains uncertain, as the recently established regulatory framework in relation to CRAs is under continued review and the success of the CRA Regulation and the Dodd-Frank Act depends on the interpretation and implementation of the new rules, which could be characterized as "children of crises"[261]. It is, therefore, highly likely that there will be further developments in this evolving area over the next years. As Steven Maijoor, ESMA Chair, said in a press release on October 2nd, 2015: "While it is encouraging to see that changes are taking place, we are realistic and know there is still work to be done".

[258] Ibid., p. 7
[259] Darbellay/Partnoy, p. 23
[260] Gortsos, p. 297
[261] Ibid.

Primary Sources

A. International Law

1. International Organization of Securities Commissions (IOSCO)

IOSCO Technical Committee (2003): Report on the Activities of Credit Rating Agencies, September

IOSCO Technical Committee (2003): Statement of Principles Regarding the Activities of Credit Rating Agencies, September

IOSCO Technical Committee (2004): Code of Conduct Fundamentals for Credit Rating Agencies, December

IOSCO Technical Committee (2008): The Role of Credit Rating Agencies in Structured Finance Markets, May

IOSCO Technical Committee (2008): Code of Conduct Fundamentals for Credit Rating Agencies, May

IOSCO Board (2013): Supervisory Colleges for Credit Rating Agencies, July

2. Financial Stability Board (FSB)

FSB (2010): Principles for Reducing Reliance on CRA Ratings, October 27th

FSB (2012): Report to G20 Finance Ministers and Central Bank Governors – Roadmap and Workshop for Reducing Reliance on CRA Ratings, November 5th

FSB (2014): Thematic Review of the FSB Principles for Reducing Reliance on CRA Ratings (final), May 12th

3. Other

G20 Leaders Declaration of June 18th-19th, 2012, Los Cabos, Mexico

B. American Law

1. Acts

Securities Act 1933 (available online at: https://www.sec.gov/about/laws/sa33.pdf)

Credit Rating Agency Reform Act 2006 (available online at: https://www.sec.gov/divisions/marketreg/ratingagency/cra-reform-act-2006.pdf)

Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (available online at: https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf)

2. Other

Securities and Exchange Commission (2008): Summary Report of Issues Identified in the Commission Staff's Examination of Select CRAs

U.S. Senate (2010): Hearing on Wall Street and the Financial Crisis: The Role of CRAs, Document no. 86, April 23rd

C. EU Law

1. Regulations of the European Parliament and of the Council

Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 "on credit rating agencies" (OJ L 302, 17.11.2009, p. 1)

Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 "establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC" (OJ L 331, 15.12.2010, p. 84)

Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 "amending Regulation (EC) No 1060/2009 on credit rating agencies" (OJ L 145, 31.5.2011, p. 30)

Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 "amending Regulation (EC) No 1060/2009 on credit rating agencies" (OJ L 146, 31.5.2013, p. 1)

2. Directives

Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 of 8 June 2011 "on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010" (OJ L 174, 1.7.2011, p. 1)

Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 "amending Directives 2003/71/EC and 2009/138/EC and Regulations (EC) No 1060/2009, (EU) No 1094/2010 and (EU) No 1095/2010 in respect of the powers of the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority)" (OJ L 153, 22.5.2014, p. 1)

Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty "on the annual accounts of certain types of companies" (OJ L 222, 14.8.1978, p. 11)

3. Other

Committee of European Securities Regulators (CESR) (2005): Technical Advice on possible measures concerning credit rating agencies, March

Committee of European Securities Regulators (CESR) (2008): Second Report to the EU Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance, May

European Commission Proposal for a Regulation of the European Parliament and of the Council of 2 June 2010 "on amending Regulation (EC) No 1060/2009 on credit rating agencies" (COM(2010) 289 final – 2010/0160 (COD))

European Commission Proposal for a Regulation of the European Parliament and of the Council of 15 November 2011 "on amending Regulation (EC) No 1060/2009 on credit rating agencies" (COM(2011) 747 final – 2011/0361 (COD))

Secondary Sources

Amtenbrink, Fabian and Klaus Heine (2013): Regulating Credit Rating Agencies in the European Union, The Dovenshmidt Quarterly 2-15, Eleven Journals

Bahena, Amanda J. (2010): What Role Did Credit Rating Agencies Play in the Credit Crisis, March (available online at: http://www.colorado.edu/AmStudies/rolecreditagencies.pdf)

Becker, Bo and Todd Milbourn (2009): Reputation and Competition: Evidence from the Credit Rating Industry, HBS Working Paper No. 09-051, Harvard Business School, February

Benmelech, Efraim and Jennifer Dlugosz (2010): The Credit Rating Crisis, NBER Macroeconomics Annual, Volume 24, University of Chicago Press

Bofinger, Peter: Public Sector Credit Rating Agencies = More Stable Financial Architecture, Dialogue on Globalization Occasional Paper No. 42

Bonewitz, Paul Lasell (2010): Implications of Reputation Economics on Regulatory Reform of the Credit Rating Industry, William & Mary Business Law Review 391 Volume 1, Issue 2, Article 4

Bruner, Christopher M. and Rawi Abdelal (2005): To Judge Leviathan: Sovereign Credit Ratings, National Law and the World Economy, Cambridge University Press

Camanho, Nelson, Pragyan Deb and Zijun Liu (2012): Credit Rating and Competition, Financial Markets Group London School of Economics and Political Science, July

Cantor, Richard, Owain ap Gwilym and Stephen Thomas (2007): The Use of Credit Ratings in Investment Management in the US and Europe, February

Cinquegrana, Piero (2009): The Reform of the Credit Rating Agencies: A Comparative Perspective, ECMI Policy Brief No. 12, February

Conte, Elisabetta and Federico Parmeggiani (2008): The Regulation of Credit Rating Agency across USA and EU: different systems, same concerns (available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2214998), November

Darbellay, Aline and Frank Partnoy (2012): Credit Rating Agencies and Regulatory Reform, Legal Studies Research Paper Series, University of San Diego, April

Dittrich, Fabian (2007): The Credit Rating Industry: Competition and Regulation (available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=991821), July

Duponcheele, Georges, William Perraudin and Daniel Totouom-Tangho (2014): Reducing the Reliance of Securitization Capital on Agency Ratings (available online at: http://www.riskcontrollimited.com/public/Reducing_the_Reliance.pdf), February

Gortsos, Christos V. (2015): The Single Supervisory Mechanism (SSM), Nomiki Bibliothiki

Gudzowski, Milosz (2010): Mortgage Credit Ratings and the Financial Crisis: the Need for a State-Run Mortgage Security Credit Rating Agency, Columbia Business Law Review, March

Hill, Claire A. (2004): Regulating the Rating Agencies, Business, Economics and Regulatory Policy Working Paper No. 452022 Volume 82:43, Georgetown University Law Center

Hunt, John Patrick (2012): Credit Rating Agencies and the "Worldwide Credit Crisis": the Limits of Reputation, the Insufficiency of Reform and a Proposal for Improvement, Rating Agency Reform

Katz, Jonathan, Emanuel Salinas and Constantinos Stephanou (2009): Credit Rating Agencies, No Easy Regulation Regulatory Solutions, Crisis Response, Public Policy for the Private Sector, The World Bank Group, Financial and Private Sector Development Vice Presidency, Note No. 8, October

Lombard, Sulette (2009): Credit Rating Agencies as Gatekeepers: What Went Wrong? (available online at: http://www.clta.edu.au/professional/papers/conference2009.pdf)

Marandola, Ginevra and Timothy Sinclair (2014): Credit Rating Agencies: A Constitutive and Diachronic Analysis, Sheffield Political Economy Research Institute Paper No.16, University of Sheffield, October

Maris, Pavlos (2009): The Regulation of Credit Rating Agencies in the US and Europe: Historical Analysis and Thoughts on the Road Ahead (available online at: http://ssrn.com/abstract=1434504), March

Mastromanolis, Emmanouel (2013): Credit Rating Agencies – Mission, Regulation, Civil Liability, Nomiki Bibliothiki (in Greek)

McClintock Ekins, Emily and Mark A. Calabria (2012): Regulation, Market Structure and Role of the Credit Rating Agencies, Policy Analysis No. 704, Cato Institute, August

McNamara, Steven (2012): Informational Failures in Structured Finance and Dodd-Frank's "Improvements to the Regulation of Credit Rating Agencies", Fordham Journal of Corporate & Financial Law Vol. XVII, June

Mennillo, Giulia and Suryapratim Roy (2014): Ratings and Regulation: A Case of an Irreversible Marriage?, Waterhead Center for International Affairs, Harvard University, September

Miglionico, Andrea (2012): Enhancing the regulation of credit rating agencies, in search of a method, Centre for Financial & Management Studies, University of London DP 104, July

Partnoy, Frank (1999): The Siskel and Ebert of Financial Markets?: Two Thumbs for the Credit Rating Agencies, Washington University Law Quarterly, Volume 77 Number 3

Partnoy, Frank (2006): How and Why Credit Rating Agencies Are Not Like Other Gatekeepers, Legal Studies Research Paper Series, Paper No. 07-46, University of San Diego School of Law, May

Partnoy, Frank (2009): Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective for the Council of Institutional Investors, Legal Studies Research Paper Series, Paper No. 09-014, University of San Diego School of Law, April

Rousseau, Stephane (2006): Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach, McGill Law Journal/Revue De Droit De McGill

Sinclair, Timothy J. (2010): Credit Rating Agencies and the Global Financial Crisis, Economic Sociology – The European Electronic Newsletter Volume 12, November

Sy, Amadou (2009): The Systemic Regulation of Credit Rating Agencies and Rated Markets, IMF Working Paper (available online at:
https://www.imf.org/external/pubs/cat/longres.aspx?sk=23030.0)

White, Lawrence J. (2010): Credit Rating Agencies and the Financial Crisis: Less Regulation of CRAs Is a Better Response, Journal of International Banking Law and Regulation, January

Wolfson, Josh and Corinne Crawford (2010): Lessons from the Current Financial Crisis: Should Credit Rating Agencies Be Re-Structured, Journal of Business & Economics Research, July