Note

Regulatory Imperialism: The Worldwide Export of European Regulatory Principles on Credit Rating Agencies

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Credit rating agencies (CRAs) are widely cited as key contributors to the recent global financial crisis, particularly for their role in the growth of the asset-backed securities debt market.[1] As originally envisioned, collateralized debt obligations (CDOs) and related structured finance products were designed to reduce investor risk through diversification.[2] Changes in the expected default rates among subprime mortgages in 2007 combined with declining property values actually concentrated investor risk and created considerable uncertainty.[3] This uncertainty led to a liquidity crisis among some institutional investors, and as the crisis worsened CRAs downgraded billions of dollars worth of subprime residential mortgage backed securities (RMBSs) and CDOs.[4]

Credit rating agencies are companies that evaluate the risk of issuers and individual debt instruments.[5] To assess the credit

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1. *See generally* Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES MAG., Apr. 27, 2008, at 36.

2. *See* TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS, REPORT OF THE TASK FORCE ON THE SUBPRIME CRISIS, 43 (2008), *available at* http://www.iasplus.com/iosco/0805ioscosubprimereport.pdf [hereinafter IOSCO, REPORT OF THE TASK FORCE].

3. *Id.* at 3–4.

4. *Id.* at 4–5.

5. STANDARD & POOR'S FIN. SVCS., GUIDE TO CREDIT RATING ESSENTIALS 3 (2009), http://www2.standardandpoors.com/spf/pdf/fixedincome/SP_CreditRatingsGuide.pdf. Issuers include corporations, financial institutions, national governments, states, cities, and municipalities. *Id.* at 7.

risk of issuers, the CRAs analyze both financial and non-financial factors, including economic circumstances, corporate governance attributes, and key performance indicators.[6] The conclusions derived from this analysis are then reflected in a credit rating. This credit rating is an opinion about the credit risk of the issue or issuer, and reflects the CRA's opinion as to the likelihood that the issuer will be able to meet its financial obligation or that the debt instrument will default.[7] Credit ratings are not absolute measures of default probability, are not intended to indicate the value of merit of an investment, and are not recommendations to buy or sell a security.[8] Despite CRAs stressing that their ratings are simply opinions, investors have relied heavily on these ratings as their method of assessing the credit risk of RMBSs and CDOs.[9] As a result, when CRA ratings of these instruments were questioned due to the high level of downgrades, investors did not have an independent way to assess the securities' risks, causing the market for the securities to dislocate.[10]

Despite the importance of credit rating agencies in most modern capital markets, CRAs remained primarily self-regulated until fairly recently.[11] Regulators first began taking notice of CRAs after they failed to downgrade Enron until very shortly before its collapse.[12] International securities regulators were the first to take action by promulgating a non-binding code of conduct for CRAs in 2004.[13] In 2006, the United States passed

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6. *Id.* at 11–12 (additionally considering competitive trends, product mix considerations, research and development prospects, patent rights, and labor relations). For an assessment of individual issues CRAs evaluate credit quality and likelihood of default based on information concerning the legal structure, relative seniority of the issuer with regard to the issuer's other debts, and the existence of external support or credit enhancements. *See id.*

7. *Id.* at 12.

8. *Id.* at 3.

9. IOSCO, REPORT OF THE TASK FORCE, *supra* note 2, at 23. Reasons for over-reliance on ratings included the complexity of the structured finance products, the limited historical performance data available on some types of assets underlying the RMBSs, and the lack of universally understood valuation methods and price discovery mechanism in the secondary market. *Id.*

10. *Id.*

11. HOWARD DAVIES & DAVID GREEN, GLOBAL FINANCIAL REGULATION: THE ESSENTIAL GUIDE 67–68 (2008).

12. *Id.* at 68–69.

13. *See* TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES (2004), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf [hereinafter IOSCO, CODE OF CONDUCT].

the Credit Rating Agency Reform Act,[14] becoming the first jurisdiction in the world to implement binding regulations on CRAs.[15] The European Union passed the most comprehensive regulation of CRAs to date in April 2009, which is set to go into effect beginning in December 2010.[16]

This Note analyzes the current regulatory regimes of the United States and the European Union, and the practical effects these regulations will have on credit rating agencies worldwide. Part I briefly outlines the history of credit rating agency regulation in the United States and the European Union, as well as the actions taken by international securities regulators. Part II compares the regulation passed by the European Union to current regulations in the United States, focusing on five areas: the scope of the regulations, corporate governance and conflicts of interest, methodologies and quality of credit ratings, disclosure and transparency, and structured finance instruments. Part II argues that in order to eliminate the potential extraterritorial and anticompetitive effects of the European Union's regulation, regulators in the European Union must find that the regulatory regime currently in place in the United States is equivalent to that of the European Union. This Note concludes that further bilateral dialogues on the implementation of the EU regulations are necessary to eliminate the potentially adverse cross-border impact that differing regulatory approaches in the United States and European Union could have on global market participants.

I. FROM SELF-REGULATION TO AN INTRICATE REGULATORY REGIME: THE EVOLUTION OF CREDIT RATING AGENCY REGULATION

A. REGULATION OF CREDIT RATING AGENCIES IN THE UNITED STATES

Since the early twentieth century, CRAs have provided

14. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified in scattered sections of 15 U.S.C.).

15. Pavlos Maris, The Regulation of Credit Rating Agencies in the US and Europe: Historical Analysis and Thoughts on the Road Ahead 11 (July 15, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1434504; *see generally* Deniz Coskun, *Credit Rating Agencies in a Post-Enron World: Congress Revisits the NRSRO Concept*, 9 J. OF BANKING REG., 264, 264–283 (2008).

16. Council Regulation 1060/2009, art. 41, 2009 O.J. (L 302) 1–31 (EC).

ratings on the creditworthiness of issuers of securities and individual debt instruments.[17] Over time the development of increasingly complex financial products, such as asset-backed securities, and the globalization of financial markets significantly increased the importance and influence of CRAs.[18] Despite performing a crucial function in international capital markets, CRAs have not been subject to the same regulatory scrutiny as securities firms or banks,[19] remaining largely self-regulated within the United States.

The U.S. Securities and Exchange Commission (SEC or Commission) first began recognizing the ratings of certain CRAs in its federal securities regulations in 1975, designating firms as Nationally Recognized Statistical Rating Organizations (NRSROs) for purposes of its net capital rules.[20] Over the years, the concept of NRSROs was further incorporated into numerous SEC rules, granting favorable regulatory treatment to institutions whose portfolio holdings consisted of securities rated highly by NRSROs.[21]

The term NRSRO was not defined in any of these rules and regulations. Instead, the SEC issued no-action letters granting recognition of NRSRO status on a case-by-case basis, originally only to Moody's Investors Service, Inc. (Moody's), Standard and Poor's Corporation (S&P) and Fitch Investors Service, Inc.

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17. *The Role of Credit Rating Agencies in the U.S. Securities Markets: Hearing Before the S. Comm. on Governmental Affairs*, 107th Cong. 131 (2002) [hereinafter *Role of CRAs Hearing*] (statement of Issac C. Hunt, Comm'r, U.S. Securities and Exchange Commission).

18. *Id.* at 131.

19. *See* DAVIES & GREEN, *supra* note 11, at 68.

20. *See* Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirements for Certain Brokers and Dealers, Exchange Act Release No. 11497, 40 Fed. Reg. 29,795 (July 16, 1975) (incorporating the term "NRSRO" for determining capital charges on different grades of debt securities under the net capital rule). "The net capital rule requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value ('haircuts') of their proprietary securities positions . . . to provide a margin of safety against losses that might be incurred by broker-dealers as a result of market fluctuations." *Role of CRAs Hearing*, *supra* note 17, at 132 (statement of Issac C. Hunt, Comm'r, U.S. Securities and Exchange Commission).

21. *See, e.g.*, SEC Money Market Funds Rule, 17 C.F.R. § 270.2a-7(a)(9) (2009) (exempting money market funds from certain valuation requirements if their portfolios are limited to securities with particular NRSRO ratings); SEC Forms for Registration Statements, 17 C.F.R. § 239.13 (2009) (allowing non-convertible debt securities rated investment grade by at least one NRSRO to be registered on Form S-3 and forego other regulations).

(Fitch).[22] A rating agency's designation as an NRSRO "did not carry any implication that the SEC approved the ratings methodologies, or had any oversight of the agencies' operations."[23] Instead, the SEC determined whether a CRA should be designated an NRSRO by asking whether the rating agency was widely accepted in the United States as an issuer of credible and reliable ratings.[24] As a result, the designation was "intended largely to reflect the view of the marketplace as to the credibility of the ratings, rather than represent a 'seal of approval' of a federal regulatory agency."[25]

Enron's collapse in 2001 pushed regulation of CRAs to the forefront, in large part because Enron's rating remained at investment grade until four days before the company went bankrupt.[26] Congress quickly began investigating the role of CRAs in Enron's collapse,[27] finding a lack of diligence in the CRAs' assessments of Enron as the primary cause of Enron's erroneous investment grade rating.[28] Based on these findings,

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22. *See* Letter from Gregory C. Yadley, Staff Attorney, Div. of Mkt. Regulation, U.S. Sec. & Exch. Comm'n, to Ralph L. Gosselin, Treasurer, Couglin and Co., Inc. (Nov. 24, 1975), 1975 SEC No-Act. LEXIS 2602. Between 1975 and 1992, only four other rating agencies were given NRSRO status: Duff and Phelps, Inc., McCarthy Crisanti & Maffei, Inc., IBCA Limited and its subsidiary, IBCA, Inc., and Thomson BankWatch, Inc, all of which have since merged with or been acquired by another agency. *See Role of CRAs Hearing*, *supra* note 17, at 134 (statement of Issac C. Hunt, Comm'r, U.S. Securities and Exchange Commission).

23. DAVIES & GREEN, *supra* note 11, at 68.

24. *See Role of CRAs Hearing*, *supra* note 17, at 133 (statement of Issac C. Hunt, Comm'r, U.S. Securities and Exchange Commission).

25. *Id.* at 133.

26. *See* Edward Wyatt, *Credit Rating Agencies Waited Months to Voice Doubt About Enron*, N.Y. TIMES, Feb. 8, 2002, at C1.

27. On March 20, 2002 the Senate Committee on Governmental Affairs held a hearing with representatives from the major CRAs as well as the then-SEC Commissioner and various law professors. *See Rating the Raters: Enron and the Credit Rating Agencies: Hearings Before the S. Comm. on Governmental Affairs*, 107th Cong. 8 (2002) (testimony of John C. Diaz, Managing Director, Power and Energy Group, Moody's Investor Service). In addition, on July 23, 2002, representatives from Moody's and S&P testified regarding their role in Enron's misleading structured finance transactions. *See The Role of the Financial Institutions in Enron's Collapse: Hearings Before the S. Permanent Subcomm. on Investigations of the S. Governmental Affairs Comm.*, 107th Cong. 278 (2002) (joint statement of John C. Diaz, Managing Director, Power and Energy Group, Moody's Investor Service & Pamela M. Stumpp, Managing Director, Chief Credit Officer, Corporate Finance Group, Moody's Investor Service); *id.* at 282 (statement of Ronald M. Barone, Managing Director, Utilities, Energy and Project Finance Group, Corporate and Government Ratings, Standard and Poor's Financial Service).

28. *See* STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 89–98

Congress called for the direct regulation of CRAs by the SEC.[29] Over the next few years, Congress conducted additional investigations,[30] culminating in the SEC's proposal of a definition of NRSRO in 2005.[31]

In 2006 Congress responded by enacting the Credit Rating Agency Reform Act of 2006 (Rating Agency Act),[32] signaling the first formal regulation of CRAs in the United States. The Rating Agency Act defines the term "NRSRO" and provides authority for the Commission to implement rules regarding the registration, recordkeeping, financial reporting, and oversight of CRAs.[33] The Rating Agency Act also outlines registration

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(Comm. Print 2002) [hereinafter FINANCIAL OVERSIGHT OF ENRON]; *see also*, STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., ENRON'S CREDIT RATING: ENRON'S BANKERS' CONTACTS WITH MOODY'S AND GOVERNMENT OFFICIALS 2–17 (Comm. Print 2003).

29. FINANCIAL OVERSIGHT OF ENRON, *supra* note 28, at 98–100.

30. For example, the Commission, pursuant to the Sarbanes-Oxley Act of 2002, issued the Report on the Role and Function of CRAs in the Operation of Securities Markets in January 2003. U.S. SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS (2003), *available at* http://www.sec.gov/news/studies/credratingreport0103.pdf. This report listed multiple issues in need of further study. *See id.* at 1–2 (listing information flow, potential conflicts of interest, alleged anticompetitive or unfair practices, reducing potential regulatory barriers to entry and ongoing oversight as issues requiring further study). The SEC subsequently issued a Concept Release, calling for comment on these issues. *See* Rating Agencies and the Use of Credit Ratings Under Federal Securities Laws, Securities Act Release No. 8236, Exchange Act Release No. 47,972, Investment Company Act Release No. 26,066, 68 Fed. Reg. 35,258 (June 12, 2003).

31. *See* Definition of Nationally Recognized Statistical Rating Organization, Securities Act Release No. 8570, Exchange Act Release No. 51,572, Investment Company Act Release No. 26,834, 70 Fed. Reg. 21,306 (proposed Apr. 19, 2005). The proposed definition of NRSRO is an entity:

> (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (ii) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and (iii) uses systematic procedures designated to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures.

Definition of Nationally Recognized Statistical Rating Organization, 70 Fed. Reg. at 21,310.

32. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified in scattered sections of 15 U.S.C.).

33. Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55,857, 72 Fed. Reg.

procedures for NRSROs[34] and calls for almost all the information submitted in a CRA's registration application to be available to the public.[35] Perhaps most importantly, the Rating Agency Act specifically prohibits the SEC from regulating "the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings."[36]

The rules enacted by the SEC in 2007[37] pursuant to the Rating Agency Act require CRAs seeking registration as NRSROs to follow certain procedures,[38] and require NRSROs to make and retain certain records,[39] file annual financial

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33,564 (June 5, 2007). NRSRO is defined as:

> A credit rating agency that: (A) has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under section 15E; (B) issues credit ratings certified by qualified institutional buyers, in accordance with section 15E(a)(1)(B)(ix), with respect to – (i) financial institutions, brokers or dealers; (ii) insurance companies; (iii) corporate issuers; (iv) issuers of asset-backed securities . . . (v) issuers of government securities, municipal securities, or securities issued by a foreign government; or (vi) a combination of one or more categories of obligors described in any clauses (i) through (v); (C) is registered under section 15E.

Credit Rating Agency Reform Act § 3 (amending 15 U.S.C. § 78c(a)(62)).

34. *See* Credit Rating Agency Reform Act § 4 (amending 15 U.S.C. § 78o-7(a)(1) to require, among other things, disclosure of performance measurement statistics, procedures and methodologies, policies, organizational structure, and conflicts of interest in applications for registration as an NRSRO).

35. *See id.* (amending 15 U.S.C. § 78o-7(a)(3) to allow lists of the twenty largest issuers and subscribers of credit rating services, amount of net revenues received therefrom, and written certifications in registration applications from institutional buyers to remain confidential).

36. *Id.* (amending 15 U.S.C. § 78o-7(c)(2)). The SEC finds this provision to strike the proper balance between promoting competition and policing NRSRO activities without second-guessing the quality of the CRAs' ratings. *See The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets: Hearing Before S. Comm. on Banking, Housing, & Urban Affairs*, 110th Cong. 48 (2007) [hereinafter *Role and Impact Hearing*] (statement of Christopher Cox, Chairman, U.S. Securities and Exchange Commission).

37. Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 Fed. Reg. at 33,564.

38. *See* SEC Nationally Recognized Statistical Rating Organization Registration Rule, 17 C.F.R § 240.17g-1 (2009) (effective Feb. 1, 2010) (requiring registration, annual certification, and the furnishing of form NRSRO).

39. *See id.* § 240.17g-2 (requiring records on the identities of credit analysts that participated in determining the credit rating, the identity of the person who approved the credit rating, whether the credit rating was solicited or unsolicited, financial reports, compliance reports, internal audit plans, credit analysis reports, and documentation of complaints, among other things).

reports,[40] implement written policies and procedures to prevent the misuse of material nonpublic information,[41] and disclose conflicts of interest.[42] NRSROs are also prohibited from engaging in unfair, coercive, or abusive practices.[43]

Shortly after these rules were implemented CRAs began receiving heavy criticism regarding the accuracy of the ratings of structured finance products, specifically subprime RMBSs and CDOs,[44] as thousands of ratings of RMBSs and CDOs worth billions of dollars were downgraded.[45] The massive downgrades led to market uncertainty and a general reduction in market liquidity.[46] According to the SEC, a primary flaw in the rating process is the fact that arrangers of RMBSs and CDOs would inform the CRAs of the rating they wished to obtain for each product and the credit analysts would simply check whether the assets were sufficient to support the desired rating.[47]

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40. *See id.* § 240.17g-3.

41. *See id.* § 240.17g-4.

42. *See id.* § 240.17g-5.

43. *See id.* § 240.17g-6.

44. *See Role and Impact Hearing*, *supra* note 36, at 49 (statement of Christopher Cox, Chairman, U.S. Securities and Exchange Commission); *id.* at 53–60 (statement of John C. Coffee, Jr., Professor, Columbia University Law School); *see also* Elliot Blair Smith, *Bringing Down Wall Street as Ratings Let Loose Subprime Scourge*, BLOOMBERG.COM, Sept. 24, 2008, http://www.bloomberg.com/apps/news?pid=20601109&sid=ah839IWTLP9s; Joshua Rosner, Op-Ed., *Stopping the Subprime Crisis*, N.Y. TIMES, July 25, 2007, at A19; Lowenstein, *supra* note 1.

45. *See* DANIELLE NAZARIAN & MARIA MIAGKOVA, MOODY'S INVESTOR SERV., CREDIT MIGRATION OF CDO NOTES, 1996-2007, FOR US AND EUROPEAN TRANSACTIONS 2 (2008), *available at* http://www.moodys.com/cust/content/content.ashx?source=StaticContent/Free%20pages/Credit%20Policy%20Research/documents/current/2007100000486949.pdf (reporting 1448 tranche downgrades in 515 CDOs during 2007, nine times the number of tranches downgraded in 2006); RAMKI MUTHUKRISHNAN & KATE SCANLIN, STANDARD & POOR'S FIN. SERVS., 78 RATINGS LOWERED ON 16 U.S. CDOS OF ABS; $14.871 BILLION IN ISSUANCE AFFECTED 2 (2008), *available at* http://www2.standardsandpoors.com/spf/pdf/media/subprime_78cdo_073108.pdf (reporting that as of July 31, 2008, S&P had downgraded $376.792 billion in CDO issuance); Glenn Costello, Fitch Ratings, PowerPoint: Update on U.S. RMBS: Performance, Expectations, Criteria 6 (2008), http://www.fitchratings.com/web_content/sectors/subprime/us_rmbs_update_feb08.pdf (reporting downgrading $23.8 billion worth of subprime RMBS tranches issued in 2006 and the first quarter of 2007).

46. *The State of the Banking Industry: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 13–14 (2008), http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=9e0f8915-32d6-425e-8e77-7b9ce0e555b7 (statement of John C. Dugan, Comptroller of the Currency).

47. *See* Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57,967, 73 Fed. Reg. 36,212 (proposed June 25, 2008).

Additionally, investigators found many factors contributed to the inaccurate ratings of RMBSs and CDOs, including: perceived lack of transparency,[48] underestimation of credit risk and faulty assumptions underlying rating methodologies,[49] as well as conflicts of interest in the "issuer pays" model, high market concentration of CRAs, and the prospect of retaliation by arrangers.[50]

Based on these concerns, the SEC promulgated various rule amendments imposing additional requirements on NRSROs in June 2008.[51] The SEC adopted the majority of these amendments, with revisions, in February 2009 intending to increase the transparency of rating methodologies, strengthen the disclosure of ratings performances, prohibit NRSROs from engaging in particular practices that create conflicts of interest, and enhance recordkeeping and reporting obligations.[52] All NRSROs were required to comply with the majority of these

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48. *The State of the Banking Industry: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 7 (2008), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=093111d0-c4fe-47f3-a87a-b103f0513f7a (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation).

49. PRESIDENT'S WORKING GROUP ON FIN. MKTS., POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 16 (2008), *available at* http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.

50. *See Role and Impact Hearing*, *supra* note 36, at 3–7 (statement of John C. Coffee, Jr., Professor, Columbia University Law School).

51. Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. at 36,212 (implementing further regulations "in order to address concerns about the integrity of [CRAs'] credit rating procedures and methodologies in the light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages.").

52. *See* Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 59,342, 74 Fed. Reg. 6456 (Feb. 9, 2009). Specifically, the rule amendments require:

> (1) an NRSRO to provide enhanced disclosure of performance measurements statistics and the procedures and methodologies used by the NRSRO in determining credit ratings for structured finance products and other debt securities on Form NRSRO; (2) an NRSRO to make, keep, and preserve additional records under Rule 17g-2; (3) an NRSRO to make publicly available on its Internet Web site in XBRL format a random sample of 10% of the ratings histories of credit ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated ("issuer-paid credit ratings") in each class of credit ratings for which it has issued 500 or more issuer-paid credit ratings, with each new ratings action to be reflected in such histories no later than six months after they are taken; and (4) an NRSRO to furnish the Commission with an additional annual report.

Id. at 6469.

amendments beginning April 10, 2009.[53] Additional rule amendments adopted by the SEC on November 23, 2009 implement new requirements for ratings of structured finance products and require broader disclosure of credit rating histories.[54] The SEC has also issued proposed rules on disclosure of compliance reviews and revenue sources, and is soliciting comments regarding new rules related to ratings of structured finance instruments.[55]

B. INTERNATIONAL REGULATION OF CREDIT RATING AGENCIES

As international financial markets became more complex and CRAs began issuing ratings across borders, international regulatory agencies responded by developing detailed informal systems to coordinate regulation efforts. The International Organization of Securities Commissions (IOSCO)[56] first took notice of CRAs in 2003 when it issued its Report on the Activities of Credit Rating Agencies[57] and corresponding Principles Regarding the Activities of Credit Rating Agencies (Principles).[58] The IOSCO Principles "state high-level objectives for which ratings agencies, regulators, issuers and other market

53. *See id.* at 6456. The amendment to Rule 17g-2(d) did not go into effect until September 9, 2009. *See* Order Providing NRSROs a Temporary Exemption from the Requirement in Rule 17g-2(d), Exhange Act Release No. 60,473, 74 Fed. Reg. 41,176, 41,177 (Aug. 14, 2009).

54. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61,050, 74 Fed. Reg. 63,832–35 (Dec. 4, 2009).

55. Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61,051, 74 Fed. Reg. 63,866 (proposed Dec. 4, 2009) (deferring consideration of a proposed rule that would require a report describing credit rating procedures and methodologies and credit risk characteristics for structured finance products, and soliciting comment regarding methods to differentiate ratings of structured finance products).

56. IOSCO is recognized as the international standard-setter for securities markets, with IOSCO members regulating more than 90% of the world's securities in over 100 jurisdictions. *See* About IOSCO, http://www.iosco.org/about/index.cfm?section=history (last visited Feb. 15, 2010).

57. *See* TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS, REPORT ON THE ACTIVITIES OF CREDIT RATING AGENCIES (2003), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf (providing an overview of key issues for regulators, citing CRA independence and conflicts of interest, issuers and disclosures, public dissemination of ratings and market timing, preferential subscriber access to information, and unsolicited ratings as the greatest issues facing regulators).

58. TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS, STATEMENT OF PRINCIPLES REGARDING THE ACTIVITIES OF CREDIT RATING AGENCIES (2003), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf.

participants should strive in order to improve investor protection and the fairness, efficiency and transparency of the securities markets and reduce systemic risk."[59] The Principles cover four primary areas: (1) quality and integrity of the rating process; (2) independence and conflicts of interests; (3) transparency and timelines of ratings disclosure; and (4) confidential information.[60]

In 2004, IOSCO published a Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO Code of Conduct or Code)[61] to serve as a guide and framework for how CRAs should implement the Principles in their individual codes of conduct;[62] the "Code is the international consensus on what regulators expect of CRAs with regard to: (1) transparency; (2) conflicts of interest; (3) CRA obligations to the investing public and issuers; (4) quality and integrity of the rating process; and (5) treatment of non-public information."[63] The IOSCO Code of Conduct is also intended to serve as a template for regulation to avoid conflicts of law between different approaches to CRA regulation by individual jurisdictions.[64] For these goals to be met, individual CRAs must incorporate the IOSCO Code of Conduct into their own codes of conduct. However, in 2007 IOSCO found that while the largest CRAs had implemented the Code extensively, many small and mid-sized firms had either only partially implemented the Code, or simply not implemented it at all.[65] IOSCO has no power to force CRAs to implement the Code; it can merely provide guidance for self-regulation or a basis for

59. *Id.* at 1.

60. *See id.* at 2–4.

61. IOSCO, CODE OF CONDUCT, *supra* note 13.

62. *See id.* at 2.

63. Letter from Greg Tanzer, Sec'y Gen., IOSCO, to Mario Draghi, Chairman, Fin. Stability Forum, Tiff Macklem, Assoc. Deputy Minister, Can. Dep't of Fin., and Rakesh Mohan, Deputy Governor, Reserve Bank of India (June 30, 2008) *in* PRACTISING LAW INSTITUTE, GLOBAL CAPITAL MARKETS & THE U.S. SECURITIES LAWS 2009: STRATEGIES FOR THE CHANGING REGULATORY ENVIRONMENT 1167 (2009).

64. *See id.* at 1168.

65. *See* TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS, CONSULTATION REPORT: REVIEW OF IMPLEMENTATION OF THE IOSCO FUNDAMENTALS OF A CODE OF CONDUCT FOR CREDIT RATING AGENCIES 15 (2007), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD233.pdf. Many of the CRAs contained in IOSCO's implementation review submitted comments clarifying or explaining their implementation. *See* TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS, COMMENTS RECEIVED ON THE CONSULTATION REPORT: REVIEW OF IMPLEMENTATION OF THE IOSCO FUNDAMENTALS OF A CODE OF CONDUCT FOR CREDIT RATING AGENCIES (2007), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD249.pdf.

laws established in individual jurisdictions.[66]

As the subprime mortgage crisis in the United States triggered extensive worldwide market disruption, international securities bodies increased their scrutiny of CRAs. In October 2007, the G-7 tasked the Financial Stability Forum (FSF) with analyzing the underlying causes of the crisis, including, among other things, an examination of the methodologies and role of CRAs in structured finance transactions.[67] The FSF report called for changing the role and use of credit ratings to enhance the resilience of the global system and preserve the advantages of integrated global financial markets.[68] The report also recommended that IOSCO revise its CRA Code of Conduct and CRAs quickly revise their own codes of conduct accordingly.[69]

IOSCO also conducted an inquiry into the role of CRAs in structured finance markets.[70] Based on this analysis and the proposals put forth by the FSF, IOSCO released its revised CRA Code of Conduct in May 2008,[71] implementing numerous

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66. *See* OLIVER VON SCHWEINITZ, RATING AGENCIES: THEIR BUSINESS, REGULATION, AND LIABILITY UNDER U.S., U.K., AND GERMAN LAW 10–11 (2007) (describing IOSCO's Code of Conduct as "soft-law").

67. Press Release, U.S. Dep't of the Treasury, Statement of G-7 Finance Ministers and Central Bank Governors (Oct. 19, 2007), *available at* http://www.treasury.gov/press/releases/hp625.htm.

68. *See* FIN. STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE 2 (2008), http://www.financialstabilityboard.org/publications/r_0804.pdf (additionally proposing the strengthening of prudential oversight of capital, liquidity and risk management, enhancing transparency and valuation, strengthening the authorities' responsiveness to risks, and creating robust arrangements for dealing with stress in the financial system).

69. *See id.* at 34. The FSF also suggested that CRAs allocate adequate resources to both the initial rating and the rating's regular review, differentiate the rating symbols used for structured products from those used on bonds, expand the initial and ongoing information provided on risk characteristics of structured products, and enhance review of the quality of the data input and due diligence performed on structured products. *See id.* at 34–37. The FSF further asked investors to address their over-reliance on ratings, and asked authorities to review their use of ratings in regulatory and supervisory frameworks. *See id.* at 37–38.

70. *See* TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS, FINAL REPORT ON THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS (2008), *available at* http://www.cmvm.pt/NR/rdonlyres/85312A11-A927-4F63-810A-082C1A2CF5F8/9759/RelIOSCOsobrePapelCRAMercProdEstrut.pdf [hereinafter IOSCO, FINAL REPORT] (finding that the IOSCO Code of Conduct should be modified to better address CRA transparency and market perceptions, independence and avoidance of conflicts of interest, and CRA competition and the interaction this competition may have on CRA independence).

71. TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES (2008), *available at*

changes, many of which were aimed at how CRAs conduct themselves with regard to ratings of structured finance products.[72] Additionally, IOSCO sought greater international coordination of CRA oversight, asking "legislators to consider the regulatory consensus represented by the IOSCO Code of Conduct when framing legislation as any fragmentation runs the risk of a reoccurrence of problems with product ratings."[73] Despite this recommendation, regulatory gaps became evident in the midst of the economic crisis.[74] In response, the G-20 called for immediate action by March 31, 2009:

> Regulators should take steps to ensure that credit rating agencies meet the highest standards of [ISOCO] and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products. This will help ensure that credit rating agencies have the right incentives and appropriate oversight to enable them to perform their important role in providing unbiased information and assessments to markets. [IOSCO] should review credit rating agencies' adoption of the standards mechanisms for monitoring compliance.[75]

Pursuant to the G-20's directive, IOSCO issued a review of the implementation of the revised IOSCO CRA Code in March 2009,[76] finding that the largest CRAs had substantially implemented the revisions, but that two-thirds of the CRAs surveyed had not addressed the revisions at all.[77] In April 2009,

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http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf [hereinafter IOSCO, REVISED CODE OF CONDUCT].

72. *See* Letter from Greg Tanzer to Mario Draghi, Tiff Macklem, and Rakesh Mohan, *supra* note 63, at 1168.

73. Press Release, Int'l Org. of Sec. Comm'ns, IOSCO Urges Greater International Coordination in the Oversight of Credit Rating Agencies (Sept. 17, 2008), *available at* http://www.iosco.org/news/pdf/IOSCONEWS126.pdf.

74. *See* Press Release, Int'l Org. of Sec. Comm'ns, IOSCO Open Letter to G-20 Summit (Nov.12, 2008), *available at* http://www.iosco.org/news/pdf/IOSCONEWS133.pdf (highlighting the risks posed by unregulated and under-regulated parts of the global market).

75. GROUP OF TWENTY, DECLARATION: SUMMIT ON FINANCIAL MARKETS AND THE WORLD ECONOMY: ACTION PLAN TO IMPLEMENT PRINCIPLES OF REFORM 2 (2008), *available at* http://www.g20.org/documents/g20_summit_declaration.pdf.

76. TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS, A REVIEW OF IMPLEMENTATION OF THE IOSCO CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES (2009), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD286.pdf.

77. *See id.* at 8 (citing several possible reasons why the revised code had not been adopted, including the European Commission's proposed regulation, resource constraints, and the fact that many of the revisions were aimed at addressing concerns with structured finance product ratings, which many smaller CRAs do not offer).

the G-20 implemented an action plan for global recovery and reform and agreed to "extend regulatory oversight and registration to Credit Rating Agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest."[78]

IOSCO recently developed a model for IOSCO members who regulate and inspect CRAs intended to create "a common understanding of the types of information that regulators around the world will find useful when inspecting a CRA against regulatory requirements based on the IOSCO CRA Code."[79] Additionally, the IOSCO Task Force on Credit Rating Agencies is being converted into a permanent standing committee in order to facilitate the convergence of regulatory approaches to CRAs.[80] The G-20 continues to focus on strengthening oversight of CRAs, and progress is being made worldwide.[81]

C. REGULATION OF CRAS IN THE EUROPEAN UNION

The European Union (EU or Community) also took notice of CRAs after Enron's collapse raised a number of international policy issues.[82] At the Oviedo Informal Economic and Financial Affairs Council in April 2002, the European Commission (EC) called for a cross-sectoral policy assessment to determine whether regulatory intervention in the area of CRAs was

78. GROUP OF TWENTY, GLOBAL PLAN FOR RECOVERY AND REFORM 4 (2009), *available at* http://www.g20.org/documents/final-communique.pdf.

79. Letter from Greg Tanzer to Mario Draghi, Tiff Macklem, and Rakesh Mohan, *supra* note 63, at 1168 (covering areas such as quality and integrity of the rating process, analyst and employee independence, and compliance).

80. *See* Press Release, Int'l Org. of Sec. Comm'ns, IOSCO Update on Credit Rating Agency Oversight 3–4 (Mar. 12, 2009), *available at* http://www.iosco.org/news/pdf/IOSCONEWS138.pdf (describing the permanent standing committee and the purposes it hopes to accomplish).

81. *See* U.S. CHAIR OF THE PITTSBURGH G-20 SUMMIT, PROGRESS REPORT ON THE ACTIONS TO PROMOTE FINANCIAL REGULATORY REFORM 18–19 (2009), *available at* http://www.g20.org/Documents/pittsburgh_progress_report_250909.pdf (finding that progress has been made with CRAs incorporating the Revised IOSCO Code of Conduct, and finding that regulators are working together to obtain compatible regulatory obligations for CRAs).

82. *See* European Comm'n, Internal Mkt. and Serv. Directorate Gen. [DG MARKT], *Note for the Informal ECOFIN Council in Oviedo, Spain: A First Response to Enron Related Policy Issues*, 1, (2002) (*prepared by* Frits Bolkestein), *available at* http://ec.europa.eu/internal_market/company/docs/enron/ecofin_2004_04_enron_en.pdf (listing financial reporting, statutory audit, corporate governance, transparency in the international financial system, financial analysts' research, and the role of rating agencies as issues of concern in the EU).

necessary within the EU.[83] The European Parliament's Committee on Economic and Monetary Affairs investigated the role of CRAs in European capital markets, concluding that "rating agencies active in Europe should be asked to register with a European Union Ratings Authority."[84] Based on this report, the European Parliament passed a resolution calling for the EC to assess whether such a registration scheme should be established and whether regulatory legislation was needed.[85]

In March 2004, the EC presented the European Securities Committee[86] with four main issues of concern: (1) the legal treatment of rating agencies' access to inside information; (2) the transparency of rating methodologies; (3) the lack of competition among CRAs; and (4) conflicts of interest within rating agencies.[87] The EC then called on the Committee of European Securities Regulators (CESR)[88] to provide the EC with technical advice related to those four issues.[89] CESR issued a comprehensive report in March 2005 stating, among other things, that they did not think EU rules should extend beyond the IOSCO Code of Conduct, and that the IOSCO Code of

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83. *Id.* at 7.

84. *Commission's Report on Role and Methods of Rating Agencies*, at 11, A5-0040/2004 (Jan. 29, 2004), *available at* http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A5-2004-0040+0+DOC+PDF+V0//EN (supporting the explanatory statement of the Motion for a Resolution on Role and Method of Rating Agencies 2003/2081(INI)).

85. Resolution on Role and Methods of Rating Agencies, EUR. PARL. DOC. 2003/2081(INI) 5 (2004) (provisional edition). The European Parliament also called upon the Commission to work closely with IOSCO and other securities market regulators to ensure any developments are globally consistent. *Id.* at 5.

86. The European Securities Committee, run by the European Commission, was formed in 2001 and provides advice on policy issues in the securities field. European Commission, European Securities Committee, http://ec.europa.eu/internal_market/securities/esc/index_en.htm (last visited Feb. 16, 2010).

87. *See* European Comm'n, European Sec. Comm., *Summary Record of the 19th Meeting of the European Securities Committee/Alternates*, 6, ESC 10/2004 (Mar. 15, 2004), *available at* http://ec.europa.eu/internal_market/securities/docs/esc/meetings/2004-03-report_en.pdf.

88. The Committee of European Securities Regulators was formed in 2001 as an independent advisory body to advise the Commission on technical details of securities litigation. *See* Press Release, European Comm'n, Financial Services: Commission Creates Two New Committees on Securities 2 (June 6, 2001), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/01/792&format=PDF&aged=1&language=EN.

89. *See* European Comm'n, *Call to CESR for Technical Advice on Possible Measures Concerning Credit Rating Agencies* (July 27, 2004), *available at* http://ec.europa.eu/internal_market/securities/docs/agencies/2004-07-27-advice_en.pdf (asking CESR for advice on specific questions to assess the need for legislation or other solutions).

Conduct will improve the quality of the rating process and enhance transparency.[90] CESR also stressed the need for a worldwide uniform approach to regulation of CRAs and encouraged close coordination between regulators in Europe and the United States.[91] The EC's own investigation generated the same conclusion, finding that the directives currently in place,[92] along with the self-regulation of CRAs based on the IOSCO Code of Conduct, sufficiently answered many of the EC's concerns and no new legislative initiatives were needed.[93]

After deciding that CRAs in the EU would remain self-regulated for the time being, the EC and CESR developed a strategy for reviewing the implementation of the IOSCO Code of Conduct.[94] CESR's initial investigation, published in December 2006, found that most CRA codes complied with the IOSCO Code of Conduct with two major exceptions: ancillary services and unsolicited ratings.[95] CESR's second report on CRA

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90. Comm. of European Sec. Regulators [CESR], *CESR's Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies*, at 50–51, CESR Doc. CESR/05-139b (Mar. 30, 2005), *available at* http://www.cesr-eu.org/popup2.php?id=3157 [hereinafter CESR, *Technical Advice*].

91. *See id.* at 53.

92. The Market Abuse Directive applies to CRAs, in addition to other financial institutions, and mandates disclosure of conflicts of interest to clients and the fair presentation of investment recommendations. Council Directive 2003/6, On Insider Dealing and Market Manipulation (Market Abuse), art. 6.5, 2003 O.J. (L 96) 16–22. The Markets in Financial Instruments Directive applies only to those CRAs undertaking investment services, and imposes a number of rules on organizational structure and operating conditions, including disclosure of conflicts of interest. Council Directive 2004/39, On Markets in Financial Instruments, arts. 13–18, 2004 O.J. (L 145) 14–17.

93. Communication from the Commission on Credit Rating Agencies, 2006 O.J. (C 59) 2–6.

94. CESR, *CESR's Report to the European Commission on the Compliance of Credit Rating Agencies with the IOSCO Code*, ¶ 2, CESR Doc. CESR/06-545 (Dec. 2006), *available at* http://www.cesr-eu.org/popup2.php?id=4093. The process involved each CRA writing a letter explaining how it had complied with the IOSCO Code of Conduct and how it had deviated from it, an annual meeting between CESR and the CRAs to discuss implementation issues, and each CRA providing CESR with an explanation for any substantial incidents that occurred with a particular issuer in its market. *Id.* ¶ 3.

95. *See id.* ¶¶ 38–49. Many CRAs did not adopt provision 2.5 of the IOSCO Code of Conduct requiring CRAs to operationally and legally separate the credit rating business and CRA analysts from any other business that may create a conflict of interest because the CRAs do not consider "rating assessment services" ancillary services. *Id.* ¶ 42. Rating assessment services refer to situations where CRAs provide issuers with the likely impact various hypothetical events, such as a merger or differences in how the debt is structured, will have on a rating. *Id.* The CRAs also chose not to comply with provision 3.9 of the IOSCO Code of Conduct which requires

compliance with the revised IOSCO Code of Conduct, published in May 2008, found that some of the improvements suggested in the 2006 report had been implemented, but CESR's expectations for improvement were only partially met.[96] This second report also contained an analysis of the role of CRAs in structured finance.[97] CESR found that while changes needed to be implemented in the areas of transparency, human resources, monitoring of ratings, and conflicts of interest,[98] there was "no evidence that regulation of the credit rating industry would have had an effect on the issues which emerged with ratings" of U.S. RMBSs and CDOs, and consequently, CESR continued to support market-driven improvements.[99] However, CESR did recommend that the EC form a CRA standard-setting and monitoring body to develop international standards for the credit rating industry.[100]

The European Securities Market Expert Group (ESME)[101] also published a report on the role of CRAs in structured finance in 2006, reaching similar conclusions.[102] Due to concerns about

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CRAs to disclose their policies and procedures regarding unsolicited ratings, whether the issuer participated in the rating process, and whether the rating was initiated at the request of the issuer because all the CRAs had different interpretations of what an unsolicited rating should be. *Id.* ¶ 46.

96. CESR, *CESR's Second Report to the European Commission on the Compliance of Credit Rating Agencies with the IOSCO Code and the Role of Credit Rating Agencies in Structured Finance*, ¶ 225, CESR Doc. CESR/08-277 (May 2008), *available at* http://www.cesr-eu.org/popup2.php?id=5049.

97. *See id.* ¶¶ 90–206.

98. *See id.* For example, CESR recommended that CRAs clearly communicate the characteristics and limitations of the ratings of structured finance products, critical model assumptions including economic explanations for the assumptions, and the particular methodologies used in the ratings. *See id.* ¶¶ 121–146. CESR further believed the market would benefit from greater transparency with regard to failed or non-issued ratings because it would help alleviate market concerns over the integrity of the rating process in structured finance products. *See id.* ¶ 205.

99. *Id.* ¶ 7.

100. *Id.* ¶ 269. CESR urged the EC to immediately contact the relevant international authorities with the aim of setting up a single international group to ensure a global perspective on standard setting and monitoring. *Id.* ¶¶ 270–275.

101. The European Securities Market Expert Group was established in March 2006 to provide legal, economic, and technical advice to the EC on the application of EU securities directives, as well as on issues of contemporary relevance in the EU securities markets including credit rating agencies and financial analysts. *See* Commission Decision 2006/288, art. 2, 2006 O.J. (L106) 1, 3 (EC).

102. EUROPEAN SEC. MKT. EXPERT GROUP [ESME], ROLE OF CREDIT RATING AGENCIES 8 (June 2008), *available at* http://ec.europa.eu/internal_market/securities/docs/agencies/report_040608_en.pdf ("Given the global nature of the business of CRAs and the existing US law, we have doubts as to whether the development of a separate EU law would produce any particular benefits . . . . We think that

whether development of a separate EU law would produce any benefits, ESME advocated for an advisory group consisting of investors/users, issuers, banks, credit experts, and the SEC to provide CESR with an informed market perspective in order to enable it to review CRAs effectively.[103]

The European Commission rejected CESR and ESME's advice for continued self-regulation, believing stronger oversight was necessary in light of the economic crisis, and that CRAs should be subject to registration in the EU.[104] In order to develop its own CRA regulation, the European Commission sought input on proposed regulatory options relating to CRA authorization and supervisory processes, in addition to a proposed directive.[105] Many international securities regulators criticized the proposed regulation.[106] The European Securitisation Forum[107] and the Securities Industry and Financial Markets Association[108] raised numerous concerns over

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regulatory cooperation in this sphere is essential to avoid duplication of effort.").

103. *Id.* at 22. ESME even stated that "full formal regulation may be counterproductive as it might be seen by users in the market place to imply a level of official endorsement of ratings which is neither justified nor feasible." *Id.*

104. DG MARKT, *Proposal for a Regulatory Framework for Credit Rating Agencies*, at 2 (2008), *available at* http://ec.europa.eu/internal_market/consultations/docs/securities_agencies/consultation-cra-framework_en.pdf. The European Commission explained why it believed self-regulation of CRAs was insufficient:

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

Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies, at 4, COM (2008) 704 final (Nov. 12, 2008).

105. *See* DG MARKT, *supra* note 104, at 1–33 (recommending various regulatory options and offering a proposed text of a directive/regulation on credit rating agencies).

106. *See generally* Letter from Rick Watson, Managing Dir., European Securitisation Forum, & Bertrand Huet-Delaherse, Managing Dir., European Legal & Regulatory Counsel, Sec. Indus. & Fin. Mkt. Ass'n, to DG MARKT (Sept. 5, 2008), *available at* http://www.sifma.org/europe/docs/Response-EU-CRA-Consultation.pdf.

107. The European Securitisation Forum (ESF), now known as AFME/ESF, addresses financial markets policy issues relating to securitization, works to build consensus within the industry, and seeks to eliminate inefficiencies in market regulation throughout Europe. *See* Association for Financial Markets in Europe, Welcome to AFME (Association for Financial Markets in Europe), http://afme.eu/dynamic.aspx?id=2294 (last visited Feb. 22, 2010).

108. The Securities Industry and Financial Markets Association (SIFMA) is an

the absence of global regulatory coordination,[109] the extraterritorial impact of the proposed legislation,[110] and the specificity of many rules which would not leave enough room for the CRAs to exercise appropriate business and professional judgment.[111] CESR further reiterated the need for international coordination and raised additional concerns about potential anti-competition effects of the proposed regulation.[112]

Despite these concerns, the EC's impact assessment concluded that formal regulatory action was needed[113] and the EC released its proposed regulation in December 2008.[114] The proposed regulation had four overall objectives: (1) ensuring CRAs avoid conflicts of interest or at least manage them adequately; (2) improving the quality of the methodologies used by CRAs; (3) increasing transparency by setting disclosure obligations; and (4) ensuring an efficient registration and surveillance framework.[115]

The proposal, as amended, was approved by the European Parliament on April 23, 2009[116] and the European Council signed the regulation on September 16, 2009[117] (EU CRA Regulation), signaling the first comprehensive regulation of CRAs in the EU. CRAs are required to apply the majority of the

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organization that represents the interests of participants in the global financial markets, including international securities firms, U.S. registered broker-dealers, and asset managers, on regulatory and legislative issues and initiatives. SIFMA, Welcome to SIFMA.org, http://www.sifma.org/about/about.html (last visited Feb. 16, 2010).

109. Letter from Rick Watson & Bertrand Huet-Delaherse to DG MARKT, *supra* note 106, at 4–5.

110. *Id.* at 6.

111. *Id.* at 7.

112. CESR, *CESR's Response to the Consultation Document of the Commission Services on a Draft Proposal for a Directive/Regulation on Credit Rating Agencies*, at 2, CESR Doc. CESR/08-671 (Sept. 16, 2008), *available at* http://www.cesr-eu.org/popup2.php?id=5222.

113. *Commission Staff Working Document Accompanying the Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies: Impact Assessment*, at 48, COM (2008) 704 (Nov. 12, 2008) ("Self-regulation has already been tested and has failed . . . . A legislative solution would be a proportionate measure to fulfill the objectives of providing for a uniform CRA regime across the EU.").

114. *Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies*, *supra* note 104.

115. *Id.* at 4.

116. *See Position of the European Parliament*, COD (2009) 217 (Apr. 23, 2009), *available at* http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TC+P6-TC1-COD-2008-0217+0+DOC+PDF+V0//EN.

117. Council Regulation 1060/2009, *supra* note 16.

regulation by December 7, 2010.[118] The regulation contains detailed provisions regarding conflicts of interest,[119] rating analysts,[120] methodologies,[121] disclosure and presentation of credit ratings,[122] transparency,[123] registration,[124] and cooperation with third countries.[125] Most importantly, the scope of the regulation extends to CRAs located outside of the European Community, allowing the use of a credit rating issued by a CRA located in a third country only when the rating activities are either endorsed by a CRA located in the Community[126] or comply with certification and equivalent requirements.[127] CESR began developing aspects of the CRA registration process in late October 2009 and must issue guidance by May 2010.[128]

II. UNDERSTANDING THE CURRENT REGULATORY REGIMES

International credit rating agencies are now subject to conflicting regulations in the United States and the European Union, and also may feel compelled to comply with the revised IOSCO Code of Conduct.[129] This represents a dramatic shift from five years ago, when CRAs operated without heightened scrutiny from government regulators. Despite the many calls for international coordination,[130] CRAs are now tasked with

118. *See Id.* art. 41. The provisions relating to endorsement shall apply beginning June 7, 2011. *Id.*

119. *Id.* art. 6.

120. *Id.* art. 7.

121. *Id.* art. 8.

122. *Id.* art. 10.

123. *Id.* art. 12.

124. *Id.* arts. 14–20.

125. *Id.* arts. 34–35.

126. *Id.* art. 4.

127. *Id.* art. 5.

128. *See* CESR, *Consultation Paper: Guidance on Registration Process, Functioning of Colleges, Mediation Protocol, Information Set Out in Annex II, Information Set for the Application for Certification and for the Assessment of CRAs Systemic Importance*, at 4, CESR Doc. CESR/09-955 (Oct. 21, 2009), *available at* http://www.cesr-eu.org/popup2.php?id=6142 [hereinafter CESR, *Consultation Paper*].

129. The EU CRA Regulation states that CRAs should apply the IOSCO Code of Conduct on a voluntary basis. Council Regulation 1006/2009, *supra* note 16, para. 8.

130. *See, e.g.*, CESR, *Technical Advice*, *supra* note 90, at 53; Council Regulation 1060/2009, *supra* note 16, arts. 34–35; Letter from Rick Watson & Bertrand Huet-Delaherse to DG MARKT, *supra* note 106, at 4–5.

implementing the complex rules and procedures promulgated in the various territories. This is a significant undertaking as the regulations permeate all aspects of the CRAs' daily operations, and the CRAs are required to implement the stricter of any conflicting rules in order to ensure compliance with the laws if they wish to issue ratings for use in the EU or the United States.[131] This section will dissect European Union regulation, comparing it to United States regulations as well as the revised IOSCO Code of Conduct.

A. USE OF CREDIT RATINGS WITHIN THE EUROPEAN UNION: ENDORSEMENT AND CERTIFICATION

The EU CRA Regulation applies to credit ratings[132] that are publicly disclosed or distributed by subscription,[133] not to private credit ratings produced pursuant to an individual order unintended for public disclosure or distribution by subscription.[134] The EU CRA Regulation specifies that credit institutions, investment firms, insurance and reinsurance undertakings, collective investment schemes, and pension funds may only use credit ratings for regulatory purposes if they are issued by a credit rating agency[135] established in the European Union and registered in accordance with the EU CRA Regulation.[136] One example of "regulatory purpose" is including

131. CRAs operating in the U.S. are subject to SEC regulations stemming from the Rating Agency Act of 2006 while CRAs wishing to issue ratings for use in the European Union would be subject to a different set of regulations in the EU CRA Regulation. *See* Amadou N.R. Sy, *The Systemic Regulation of Credit Rating Agencies and Rated Markets* 24-26 (Int'l Monetary Fund, Working Paper No. WP/09/129, 2009), *available at* http://www.imf.org/external/pubs/ft/wp/2009/wp09129.pdf.

132. "Credit rating" is defined as "an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories." Council Regulation 1060/2009, *supra* note 16, art. 3(1)(a). A credit rating does not include recommendations within the meaning of Article 1(3) of Directive 2003/125/EC, investment research or other forms of general recommendation such as "buy," "sell," or "hold," or opinions about the value of a financial instrument or financial obligation. *Id.* art. 3(2).

133. *Id.* art. 2(1).

134. *Id.* art. 2(2)(a). The EU CRA Regulation also does not apply to credit scores, credit scoring systems, credit ratings produced by export credit agencies, and credit ratings produced by central banks. *See id.* art. 2(2)(b)–(d).

135. A "credit rating agency" is defined as "a legal person whose occupation includes the issuing of credit ratings on a professional basis." *Id.* art. 3(1)(b).

136. *Id.* art. 4(1). A "credit institution" is "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its

a reference to a credit rating in a prospectus for a public offering or for being listed on an exchange in the EU.[137] The regulation does not completely ban the listed institutions from using ratings of non-EU CRAs for regulatory purposes. Instead, if an institution wishes to utilize the credit rating issued by a CRA located outside of the Community for a regulatory purpose, the rating must be deemed eligible either through endorsement or certification.[138]

A CRA located in the EU and registered pursuant to the EU CRA Regulation may endorse the rating of a non-EU CRA only if numerous conditions are satisfied. First, the endorsing EU CRA and the non-EU CRA must belong to the same group.[139] This means that any CRA based outside of the Community which is considered systemically important, or any CRA that wishes to qualify through endorsement rather than certification, must establish a subsidiary within the Community.[140] "Systemic importance" is not defined in the regulation, but presumably implies the largest CRAs based in the United States, Japan, and Canada.[141] Second, the non-EU CRA must be authorized or registered, and subject to supervision in that third country.[142] Finally, the non-EU CRA must fulfill requirements relating to conflicts of interest, rating analysts, methodologies, outsourcing, disclosure, and transparency which are at least as stringent as those in the EU CRA Regulation.[143] While the term "at least as stringent" is not defined in the EU CRA Regulation, a CRA merely complying with the U.S. Rating Agency Act and the revised IOSCO Code of Conduct likely would not meet this standard, as this Section will make apparent.

The endorsing EU CRA must also meet numerous

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own account." Directive 2006/48, art. 4(1), 2006 O.J. (L 177) (EC). A "regulatory purpose" is defined as "the use of credit ratings for the specific purpose of complying with Community law, as implemented by the national legislation of the Member States." Council Regulation 1060/2009, *supra* note 16, art. 3(1)(g).

137. *See* Council Regulation 1060/2009, *supra* note 16, art. 2(1).

138. *See id.* art. 4(3)–5.

139. *Id.* art. 4(3)(a). A "group of credit rating agencies" means a parent company and its subsidiaries and/or affiliated companies, including those credit rating agencies established in third countries. *Id.* art. 3(1)(m).

140. *See id.* para. 13.

141. *See* CESR, *Call for Evidence: Fact Finding Exercise of the Use in the European Union of Ratings Issued by Third Country CRAs*, CESR Doc. CESR/09-681 (July 3, 2009), *available at* http://www.cesr-eu.org/popup2.php?id=5785 [hereinafter CESR, *Call for Evidence*].

142. Council Regulation 1060/2009, *supra* note 16, art. 4(3)(f).

143. *See id.* art. 4(3)(b).

obligations. The EU CRA must verify that the requirements outlined in the EU CRA Regulation are being met by the non-EU CRA,[144] demonstrate that there is an objective reason for the rating to be done in a third country,[145] and make information available to the EU regulator so the regulator can supervise the non-EU CRA's compliance with the EU CRA Regulation.[146] The effect of these provisions is to ensure that any systemically important CRA based outside of the Community is subject to the same regulations and supervision as any CRA located in the EU, thereby forcing all non-EU CRAs to comply with the strict provisions outlined in the EU CRA Regulation.

Additionally, in order to qualify for endorsement, the non-EU CRA must rely on both EU and third-country regulators to fulfill their obligations under the regulation.[147] The non-EU regulator must either prevent public authorities of the third country from interfering with the content of CRA methodologies and ratings,[148] or establish a supervisory framework equivalent to the EU CRA Regulation.[149] Meanwhile, the EU regulator of the "Home Member State" is responsible for assessing and monitoring the compliance of the non-EU CRA with the regulations.[150] Both regulatory regimes are responsible for entering into an appropriate cooperation agreement covering the exchange of information, as well as procedures concerning the coordination of supervisory activities.[151]

Alternatively, credit ratings issued by a CRA located outside of the European Community may be used if the non-EU CRA complies with the certification process outlined in the EU CRA Regulation.[152] Like the endorsement requirements, a non-EU CRA wishing to qualify through the certification process must be authorized or registered in and subject to supervision in that third country,[153] and the EU and non-EU regulators must

144. *Id.*
145. *Id.* art. 4(3)(e).
146. *Id.* art. 4(3)(d).
147. *See id.* art. 4(3).
148. *Id.* art. 4(3)(g).
149. *Id.* art. 4(6).
150. *Id.* art. 4(3)(c). "Home Member State" is defined as the "Member State in which the credit rating agency has its registered office." *Id.* art. 3(1)(c).
151. *Id.* art. 4(3)(h).
152. *See id.* art. 5(1).
153. *Id.* art. 5(1)(a).

enter into a cooperation agreement.[154] The European Commission must then adopt an equivalence decision recognizing that the legal and supervisory framework of that third country is equivalent to the EU CRA Regulation.[155] Thereafter, the non-EU CRA must apply for certification under the same registration process applied to CRAs located in the European Community.[156] Only CRAs deemed not to be "of systemic importance to the financial stability or integrity of the financial markets of one or more Member States" will be allowed to qualify through certification.[157] CESR considers the matter of determining systemic importance an issue for competent authorities of all member states, and has proposed that each member state tell CESR what activities it considers to be of systemic importance in its respective jurisdiction.[158]

CESR has issued some guidance on its intended approach for determining endorsement and certification.[159] CESR does not plan on making authorities check every rating that is going to be endorsed, but indicated that CRAs should be able to prove at any time that all the endorsements issued comply with the requirements of the EU CRA Regulation.[160] CESR also stated that the EU CRA must clearly identify an endorsed rating as such.[161] If a CRA seeks to have its ratings qualify for use in the EU via certification, CESR only requires one submission for the entire group of related CRAs.[162] Once granted, the certification would be effective for the entire territory of the European Community.[163]

Both the certification and endorsement provisions could have considerable extraterritorial implications because the EU CRA Regulation is imposed on CRAs regardless of where they are domiciled.[164] Some CRAs have argued that the EU CRA

154. *Id.* art. 5(1)(c).
155. *Id.* art. 5(1)(b).
156. *See id.* art. 5(2).
157. *See id.* art. 5(1)(d).
158. *See* CESR, *Consultation Paper*, *supra* note 128, ¶ 84.
159. *See id.* ¶¶ 10–274 (seeking comment on the proposed CESR guidance).
160. *See id.* ¶ 70.
161. *Id.*
162. *See id.* ¶ 77.
163. *Id.* ¶ 79.
164. *See* Sec. Indus. and Fin. Mkt. Ass'n [SIFMA], Global Advocacy Issues 8 (May 29, 2009) (discussion slides available at http://www.prmia.org/Chapter_Pages/Data/Files/3226_3508_Global%20Advocacy%20Issues._other1.pdf); *see also* JOINT RESPONSE BY HM TREASURY, THE FINANCIAL SERVICES AUTHORITY (FSA), AND THE BANK OF ENGLAND TO THE COMMISSION CONSULTATION ON: A DRAFT

Regulation captures the entirety of the global credit ratings business because all ratings issued are available to all investors, regardless of where they are based, and any institution that is subject to EU regulation may decide to use its ratings for regulatory purposes.[165] The extraterritorial reach of the regulation turns on whether a particular jurisdiction's regulatory regime is considered "at least as stringent" as the EU CRA Regulation. CESR argues that there is no objective reason to set different requirements for non-EU CRAs depending on the mechanism used, so the quality requirements for credit ratings endorsed and credit ratings issued by a certified CRA should not be different.[166] Thus, a decision by the European Commission recognizing the equivalence of a third country's legal and supervisory framework would be sufficient for an endorsing EU CRA to demonstrate that the non-EU CRA fulfils requirements at least as stringent as those set out in the EU CRA Regulation.[167]

In the past, equivalency focused more on whether the regulatory regime broadly achieved equivalent outcomes. For example, in 2008 the EU deemed the Generally Accepted Accounting Principles of the United States, Canada, and Japan equivalent to its International Financial Reporting Standards, despite some major differences.[168] Due to the subprime mortgage crisis, the EU may be in a position to assert regulatory leadership, causing equivalency determinations for CRAs to be

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DIRECTIVE/REGULATION ON THE AUTHORISATION, OPERATION AND SUPERVISION OF CREDIT RATING AGENCIES (CRAS) AND POLICY OPTIONS TO ADDRESS THE PROBLEM OF EXCESSIVE RELIANCE ON CREDIT RATINGS 2 (Sept. 5, 2008), http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/authorities/uk_ministrypdf/_EN_1.0_&a=d [hereinafter HM TREASURY]; Letter from Jonathan Taylor, Chairman, Int'l Council of Sec. Ass'ns [ICSA], & Marilyn Skiles, Sec'y Gen., ICSA, to DG MARKT 2 (Sept. 5, 2008), *available at* http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/citizens/international_associatio/_EN_1.0_&a=d; Letter from Vickie A. Tillman, Executive Vice President, Standard and Poor's Ratings Servs., to DG MARKT 3 (Sept. 5, 2008), *available at* http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/citizens/standard_poorspdf/_EN_1.0_&a=d.

165. *See, e.g.*, Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 3, 11.

166. *See* CESR, *Consultation Paper*, *supra* note 128, ¶¶ 88, 90–91.

167. *See id.* ¶ 91.

168. *See* Council Directive 2008/961, Commission Decision of 12 December 2008 on the Use By Third Countries' Issuers of Securities of Certain Third Country's National Accounting Standards and International Financial Reporting Standards to Prepare Their Consolidated Financial Statements, 2008 O.J. (L 340) 112 (EC).

based on more detailed evaluations involving a line-by-line comparison of rules and regulations. "The European Commission service's informal view communicated to CESR clearly states their understanding that [the endorsement provisions] should be interpreted as requiring local legal and regulatory system[s] to impose requirements as stringent as those found" in the EU CRA Regulation.[169] Thus, the EU is essentially hinging non-EU CRAs' abilities to qualify for endorsement or certification on the regulatory authorities located in their home countries. If a non-EU regulator wishes to allow CRAs domiciled within its jurisdiction the right to issue ratings for use in the EU, but does not already have a regulatory regime at least as stringent as the EU's, it may have to comply with the EU CRA Regulation, including entering into cooperation agreements with EU regulators.[170] Consequently, non-EU regulators may be forced to abide by provisions they did not adopt.[171]

The equivalency determination also raises practical implementation questions about what happens if non-EU regulators are unable to fulfill their obligations or choose not to satisfy the necessary requirements.[172] It seems unfair to bar the use of credit ratings in the EU if they are issued by non-EU CRAs who are otherwise in compliance with all provisions in the EU CRA Regulation. However, the EU CRA Regulation does not provide any exceptions for such a situation, reasoning that:

> [T]hird-country CRAs need to be subject to supervision and possible enforcement by the relevant authority of the third-country for endorsement to be effective. . . . If the requirements for endorsement could be established on a voluntary basis the risk of noncompliance by the third-country CRA would be significantly higher.[173]

The EU CRA Regulation provides an eighteen month transition period until June 7, 2011 for the endorsement provisions.[174] During that time, the endorsing CRA will confirm to EU authorities that the non-EU CRA has met the

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169. CESR, *Consultation Paper*, *supra* note 128, ¶ 93.

170. *See* Council Regulation 1060/2009, *supra* note 16, art. 5. The EU CRA Regulation does, however, provide for limited exceptions. *Id.* art. 5(4).

171. *See supra* text accompanying note 169.

172. *See* M. Madelain & N. Phipps, Moody's Investor Services, Presentation to the IOSCO Standing Committee: Regulation of CRAs: Global Perspective 6, 12–23 (July 15, 2009) (discussion slides on file with author).

173. CESR, *Consultation Paper*, *supra* note 128, ¶¶ 94–95.

174. Council Regulation 1060/2009, *supra* note 16, art. 41.

requirements on a self-imposed basis if there was no equivalent local regulatory regime.[175] After that date, however, the CRAs without an exemption and whose home regulatory regimes are not deemed equivalent to or as stringent as the EU CRA Regulation have to establish and register a subsidiary within the European Community and conduct all rating activities for use in the EU through that entity.[176]

The three largest CRAs (Moody's, S&P, and Fitch) are based in the United States, and no CRA based in the EU is a Nationally Recognized Statistical Rating Organization (NRSRO) in the United States.[177] In the event that no CRA is exempted and no regulatory regimes are deemed equivalent to, or at least as stringent as the EU CRA Regulation, only those ratings developed entirely within the EU would be eligible for regulatory purposes.[178] This could hinder the flow of capital between Europe and non-EU jurisdictions, thus lessening European investment opportunities.[179] It could also impact the ability of foreign governments or companies to raise capital in the EU.[180] Finally, if the EU-based CRAs choose not to, or are unable to, rate securities outside of the EU, the EU financial institutions would not be able to invest in non-EU debt securities.[181] Even if the smaller EU CRAs did rate debt outside of the EU, their ratings may not be viewed as being of sufficient quality, and their regulatory use by EU financial firms may raise concerns among other market participants.[182]

The EU CRA Regulation's certification requirement could also have anti-competitive effects, serving as a barrier to entry into the EU market.[183] While many of the U.S. based CRAs have

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175. CESR, *Consultation Paper*, *supra* note 128, ¶ 100.

176. *See* Council Regulation 1060/2009, *supra* note 16, art. 5.

177. *See* Sec. & Exch. Comm'n, Spotlight on Nationally Recognized Statistical Rating Organizations ("NRSROs"), http://www.sec.gov/divisions/marketreg/ratingagency.htm (last visited Feb. 17, 2010).

178. *See* Council Regulation 1060/2009, *supra* note 16, art. 5.

179. *See* Letter from Yasuhiro Harada, Chairman and Co-Chief Executive Officer, Rating and Investment Information, Inc., to Jörgen Holmquist, Dir. Gen., Internal Mkt. and Servs., European Comm'n 4 (Sept. 5, 2008), *available at* http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/citizens/ri_japanpdf/_EN_1.0_&a=d.

180. SIFMA, *supra* note 164, at 8.

181. *See supra* Part II.A.

182. *See supra* Part II.A.

183. *See generally* Letter from Yasuhiro Harada to Jörgen Holmquist, *supra* note 179, at 4 (claiming that Article 3 could compel non-Community-based CRAs to cease operations in the European Community); Letter from Takefumi Emori,

subsidiaries in the EU, two of the largest CRAs in Asia, Rating and Investment Information, Inc. and Japan Credit Rating Agency, Ltd., do not currently have subsidiaries in the EU.[184] Rating and Investment Information, Inc. primarily assigns ratings on bonds issued in Japan, but it also assigns ratings to bonds issued in the European Community's markets, including finance subsidiaries of Japanese corporations, EU sovereign governments, and EU issuers.[185] Similarly, Japan Credit Rating Agency, Ltd. primarily rates corporations and financial institutions in Japan, but those ratings can be utilized by banking institutions in the EC for risk weight assessment.[186] While the volume of rating activities each CRA performs in the EU is relatively small, they are both large CRAs likely to be deemed systemically important, and thus would not be able to use the certification procedure.[187] Instead, these CRAs would have the burden of establishing EU-based subsidiaries to issue these ratings.[188] Such an action may be deemed too costly in relation to the amount of revenue such rating activities would generate, causing CRAs like Japan Credit Rating Agency, Ltd. or Rating and Investment Information, Inc. to withdraw from the Community altogether.[189] Even for entities not found to be systemically important, many jurisdictions' regulations likely will not be deemed equivalent because the EU CRA Regulation extends beyond the IOSCO Code of Conduct and ratings issued by these unqualified CRAs would be disbarred, thereby limiting competition within the EU.[190]

The European Commission is currently seeking technical

Managing Dir., Japan Credit Rating Agency, Ltd., to the European Comm'n 2 (Sept. 5, 2008), *available at* http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/citizens/jcr_japanpdf/_EN_1.0_&a=d (noting that the requirement of having a subsidiary or branch in the Community could prevent some non-Community-based CRAs from operating in the Community completely).

184. *See* Letter from Yasuhiro Harada to Jörgen Holmquist, *supra* note 179, at 3; Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 2.

185. Letter from Yasuhiro Harada to Jörgen Holmquist, *supra* note 179, at 3.

186. Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 2 (providing the example of EC banking institutions using the ratings for risk weight assessment under Basel II).

187. *See supra* text accompanying note 140.

188. *See supra* text accompanying note 140.

189. *See supra* text accompanying note 140; *see also* Letter from Yasuhiro Harada to Jörgen Holmquist, *supra* note 179, at 4.

190. *See* Edmund Parker & Miles Bake, *Regulation of Credit Rating Agencies in Europe*, 24 BUTTERWORTHS J. OF INT'L BANKING & FIN. L. 401, 402 (2009).

advice from CESR regarding whether the regulatory frameworks in the United States, Japan, and Canada are equivalent, as well as whether additional jurisdictions should be assessed.[191] The outcome of CESR's investigation should provide additional insight into the rigidity of the "equivalence" requirement, and the extent to which the EU CRA Regulation will have anti-competitive or extraterritorial effects.

B. CORPORATE GOVERNANCE AND CONFLICTS OF INTEREST

The IOSCO Code of Conduct, the U.S. Rating Agency Act, and the EU CRA Regulation all include provisions covering conflicts of interest, but the specificity and scope of the provisions vary greatly, creating another area of potential conflict. The EU CRA Regulation provides detailed requirements relating to the organizational structure and corporate governance of CRAs as a way to avoid conflicts of interest.[192] For example, CRAs must establish administrative or supervisory boards to ensure that credit rating activities are independent, properly identify conflicts of interest, and maintain agency compliance with the regulation requirements.[193] At least one-third of the board's members, but no less than two members, must be independent and uninvolved in credit rating activities.[194] At least one of these independent members and one other member of the board are required to have "in-depth knowledge and experience at a senior level of the markets in structured finance instruments" if the CRA issues credit ratings of structured finance instruments.[195] The regulation also stipulates requirements regarding the compensation, term length, dismissal, and financial expertise of the independent members.[196] Finally, the independent members are given the task of monitoring, among other things, the

191. *See* Letter from Jörgen Holmquist, Dir. Gen., Internal Mkt. and Servs., European Comm'n, to Eddy Wymeersh, Chairman, CESR (June 12, 2009), *available at* http://ec.europa.eu/internal_market/securities/docs/cesr/cesr_mandat20090612_en.pdf.

192. *See* Council Regulation 1060/2009, *supra* note 16, annex I, § A.

193. *Id.* annex I, § A(1).

194. *Id.* annex I, § A(2).

195. *Id.*

196. *Id.* The regulation requires independent members' compensation to be separate from the business performance of the CRA to ensure independence of their judgment. *Id.* It also provides that independent members cannot serve more than a five-year non-renewable term. *Id.* Dismissal of an independent board member is only allowed in the case of misconduct or professional underperformance. *Id.*

development of the methodologies used by the CRA and the effectiveness of internal controls.[197]

Many CRAs expressed concern about the ability of the EU to regulate their corporate governance standards, especially given the fact that most CRAs are headquartered outside of the EU and therefore subject to separate corporate governance standards.[198] For example, Moody's is listed on the New York Stock Exchange (NYSE) and therefore complies with NYSE's Corporate Governance Listing Standards, which differ from the standards outlined in the EU CRA Regulation.[199] Similarly, under Japanese law, shareholders have the right to elect the executive and non-executive members of the board of directors at shareholder meetings.[200] Japanese shareholders may find it excessively intrusive, and a violation of their rights, to be forced to limit the terms of office of the non-executive members of the board in order to comply with the EU CRA Regulation.[201] A.M. Best, another U.S.-based rating agency, argued that it is under no obligation to have independent board members as a privately held company headquartered in the United States.[202] The extraterritorial reach of these provisions could be extreme if they obligate non-EU CRAs to abandon their current corporate governance arrangements, which comply with the laws in their respective jurisdictions, and non-EU regulators are forced to change their corporate governance standards in order for CRAs based in their jurisdictions to be deemed equivalent in the EU.

It is also unclear how the requirement to have independent members on an administrative or supervisory board would apply within a group structure.[203] Standard and Poor's expressed concern that a subsidiary will frequently not have any

197. *Id.* annex I, § A(2)(a), (b).

198. *See* Letter from Michel Madelain, Chief Operating Officer, Moody's Investors Serv., to Maria Valentza, Head of the Sec. Unit, DG MARKT 2–6 (Sept. 5, 2008), *available at* http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/citizens/moodyspdf/_EN_1.0_&a=d; *see also* Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 3; Letter from Yasuhiro Harada to Jörgen Holmquist, *supra* note 179, at 5; Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 3.

199. *See* Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 3.

200. Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 3.

201. *Id.*

202. Letter from Larry G. Mayewski, Executive Vice President and Chief Rating Officer, A.M. Best Co., to European Comm'n 3 (Sept. 5, 2008), *available at* http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/citizens/am_bestpdf/_EN_1.0_&a=d.

203. Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 19.

independent board members, but the regulation does not clarify if the board of the parent company in those circumstances is to be treated as the administrative or supervisory board or if both the parent and the subsidiary will be required to appoint non-executive directors.[204] This requirement places particular pressure on systemically important CRAs because they must establish subsidiaries in the EU to endorse the ratings of their non-EU based affiliates.[205] This means they could potentially have more than one administrative or supervisory board with each required to comply with the corporate governance standards outlined in the EU CRA Regulation.[206]

The independent board member requirements also raise a number of other concerns. First, they could have "the unintended consequence of inhibiting credit rating agent competition in the EU."[207] Additionally, the regulations "inappropriately weight the knowledge base of CRA's non-executive board members toward the structured finance industry."[208] Requiring the independent members to monitor the methodologies, quality control systems, and compliance processes used by the CRA could make it hard for CRAs to find and retain independent board members since most non-executive directors would be reluctant to assume such responsibility.[209] Assigning these obligations to independent board members may even erode their objectivity and independence by implicating them in day-to-day decision making.[210] The extensive regulation of independent board

204. *Id.*
205. *See supra* text accompanying note 140.
206. *See supra* text accompanying note 140.
207. Letter from Larry G. Mayewski to European Comm'n, *supra* note 202, at 3.
208. Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 5.
209. *Id.* at 6.
210. *Id.* at 4. "[N]on-executive or independent directors are seen as being valuable precisely because they will bring a *different* perspective to the deliberations of the Board. It is generally the role of non-executive or independent directors '*to exercise objective independent judgment on corporate affairs*.'" Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 18–19 (citing Organisation for Economic Co-Operation and Development, OECD Principles of Corporate Governance 63 (2004), *available at* http://www.oecd.org/dataoecd/32/18/31557724.pdf). "Therefore, the expectation, in many jurisdictions at least, is that the non-executives' role is not to act as experts in order to monitor the work of the executives, officers, and employees of the group . . . ." *Id.* at 19. It seems imprudent to require such a central monitoring function to be handed over to independent members "with no long-term stake in the reputation of the CRA." Letter from Stephen W. Joynt, President and Chief Executive Officer, Fitch Ratings, to DG MARKT 6 (Sept. 5, 2008), *available at* http://circa.europa.eu/

members is a significant change from the self-regulatory regime under which CRAs previously operated, and is considerably more prescriptive than the IOSCO Code of Conduct and the U.S. Rating Agency Act.[211]

The EU CRA Regulation also contains specific provisions aimed at rating analysts that are inconsistent with the IOSCO Code of Conduct and the U.S. Rating Agency Act. The regulation requires CRAs to establish gradual rotation mechanisms so that rating analysts cannot be involved in rating activities related to the same entity or its related third parties for more than five years.[212] This could negatively impact the quality of ratings and will be extremely costly and burdensome to implement.[213] The quality of ratings in smaller, more concentrated sectors, such as structured finance securities, is especially at risk as the requirement limits analyst and committee experience by forcing board members to rotate.[214]

This rule is aimed at concerns that the excessive familiarity of an analyst and a rated enterprise creates conflicts of interest that could influence the credit ratings issued.[215] However, credit rating decisions are made by ratings committees, not single analysts, and these ratings committees consist of analysts from different teams and different sectors.[216] Thus, it is arguably

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Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/citizens/fitchpdf/_EN_1.0_&a=d.

211. Neither the revised IOSCO Code of Conduct or the U.S. Rating Agency Act contain any provisions relating to the corporate governance of CRAs.

212. Council Regulation 1060/2009, *supra* note 16, art. 7(4); *see also id.* annex I, § C(8). Lead analysts must rotate every four years and approvers must rotate every seven years. *Id.*

213. *See* Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 21–22 (stating that Moody's might have to recruit solely in order to be able to rotate analysts); *see also* Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 2; HM TREASURY, *supra* note 164, at 18; Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 34.

214. CENTRE FOR EUROPEAN POLICY STUDIES, REPORT OF THE CEPS-ECMI JOINT WORKSHOP ON "THE REFORM OF CREDIT RATING AGENCIES" 3 (2008), http://www.eurocapitalmarkets.org/files/Report_CRAMeeting_19Nov08%20FinalII.pdf; *see also* Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 2 (stating that the requirement will likely impede the analysts' progress in gaining knowledge and expertise about a particular business sector because some business sectors are comprised of only a few unaffiliated enterprises); HM TREASURY, *supra* note 164, at 18; Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 34.

215. *See* Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 2–3.

216. *See* Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 21; *see also* Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 2.

unnecessary to rotate analysts.[217] Rather than mitigating potential conflicts of interest, the effect of requiring analyst rotation could be decreased competition if small or medium-sized CRAs are unable to comply with this provision.[218]

The EU CRA Regulation also places employment restrictions on analysts, prohibiting any rating analyst or employee of a CRA from taking a key management position with an entity he or she rated, or its related third party, within six months of the credit rating.[219] "Key management position" is not defined in the regulation, making it unclear exactly what positions analysts would be barred from taking.[220] CRAs based in the United States, the United Kingdom, and Japan all expressed concerns about the legality and enforceability of this employment restriction in their respective jurisdictions.[221] Furthermore, this requirement could make it difficult for CRAs to compete for talented people who may prefer to work for an employer that does not restrict their career advancement opportunities.[222] Finally, the employment restriction provision, like the analyst rotation requirement, misunderstands the role of individuals in the rating process; an individual cannot make or break ratings for particular entities which they may later join.[223]

Under the EU CRA Regulation, credit rating agencies are additionally tasked with ensuring that its rating analysts and other employees directly involved in credit rating activities have "appropriate knowledge and experience for the duties assigned."[224] This contrasts with the revised IOSCO Code of

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217. *See* Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 2; *see also* Letter from Yasuhiro Harada to Jörgen Holmquist, *supra* note 179, at 10 (stating that the same goal can be achieved with rating committees where analysts in charge of the rated entity do not have voting rights at the rating committee).

218. *See* Letter from Yasuhiro Harada to Jörgen Holmquist, *supra* note 179, at 10 (stating that it may be impossible for some smaller CRAs to comply with this due to limited management resources); Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 2 (arguing that the provision creates a competitive disadvantage for small to medium-sized CRAs).

219. Council Regulation 1060/2009, *supra* note 16, annex I, § C(7).

220. *See* Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 41.

221. *See* Letter from Yasuhiro Harada to Jörgen Holmquist, *supra* note 179, at 18; HM TREASURY, *supra* note 164, at 23; Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 5.

222. Letter from Stephen W. Joynt to European Comm'n, *supra* note 210, at 10; *see also* Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 41.

223. Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 42.

224. Council Regulation 1060/2009, *supra* note 16, art. 7(1).

Conduct, which requires CRAs to "use people who, individually or collectively (particularly where rating committees are used) have appropriate knowledge and experience."[225] While there is only a slight difference between the two provisions, the missing phrase "or collectively" in the EU CRA Regulation could provide regulators a platform from which to question the opinions of individual analysts.[226]

In another attempt to reduce conflicts of interest, the EU CRA Regulation prohibits CRAs from providing "consultancy or advisory services to the rated entity or a related third party regarding the corporate or legal structure, assets, liabilities or activities of that rated entity or related third party."[227] The regulation, however, does not explicitly prohibit ancillary services such as market forecasts, estimates of economic trends, and pricing analysis so long as providing these ancillary services does not create conflicts of interest.[228] These provisions are similar to those in the revised IOSCO Code of Conduct which suggests CRAs should separate credit rating business from other business of the agency, including consulting.[229] While these requirements may decrease potential conflicts of interest, there are no similar requirements for consultancy or advisory services in the U.S. Rating Agency Act. [230]

Despite these differences, there are some similarities between the three regulations. Most importantly, rating analysts or approvers are prohibited from making proposals or recommendations regarding the design of structured finance instruments on which the CRA is expected to issue a credit rating.[231] The impact this regulation will have on CRAs remains to be seen, but it is likely to have a significant effect on the iterative process arrangers and CRAs typically employ, and it will likely make arrangers' tasks more difficult if they cannot receive recommendations as to what changes are necessary to achieve a particular rating.[232] The Securities Industry and

225. IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 1.4.
226. Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 19.
227. Council Regulation 1060/2009, *supra* note 16, annex I, § B(4).
228. *Id.* annex I, § B(4).
229. IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 2.5.
230. *See generally* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, § 4, 120 Stat. 1327 (amending 15 U.S.C. § 78o-7(c)(2)).
231. *Compare* Council Regulation 1060/2009, *supra* note 16, annex I, § B(5), *with* SEC NRSRO Conflicts of Interest Rule, 17 C.F.R. § 240.17g-5(c)(5) (2009) (effective Feb. 1, 2010), *and* IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 1.14-1.
232. *See* MORRISON & FOERSTER LLP, THE EU RATING AGENCY REGULATION 5

Financial Markets Association task force noted that it believes the iterative process is a core service, not an advisory function, and therefore would not be included within these provisions.[233]

All three regulations contain general provisions requiring CRAs to eliminate, manage, and disclose any conflicts of interest of employees.[234] Each regulation specifically prohibits analysts or approvers from participating in fee negotiations with the rated entity,[235] from receiving money, gifts, or favors from anyone which the CRA does business with,[236] and from owning financial instruments of the rated entity, a related entity, or an entity with which they have a business relationship.[237] Finally, the regulations require that the CRAs designate a compliance officer to ensure compliance with the CRA's policies and procedures.[238] While these provisions are relatively the same

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(2009), http://www.jdsupra.com/post/fileServer.aspx?fName=065cb65e-0cd7-4915-819b-39584771aa53.pdf.

233. *Id.*

234. *Compare* Council Regulation 1060/2009, *supra* note 16, annex I, § B(1), (requiring CRAs to "identify, eliminate or manage and disclose . . . conflicts of interest" but not requiring written protocols for such measures), *with* 17 C.F.R. § 240.17g-5(a) (prohibiting conflicts of interests unless the CRA discloses such conflict and is "enforcing written policies and procedures to address and manage conflicts of interest"), *and* IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 2.6 (advising CRA's to "adopt written internal procedures and mechanisms to (1) identify, and (2) eliminate, or manage and disclose" conflicts of interest).

235. *Compare* Council Regulation 1060/2009, *supra* note 16, art. 7(2), (specifying the scope of the prohibited entity to include "any person directly or indirectly linked to the rated entity by control"), *with* 17 C.F.R. § 240.17g-5(c)(6) (prohibiting analysts from participating in negotiations, discussions, or arrangements of fee-payments in general), *and* IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 2.12 (prohibiting analysts from involvement in fee-arrangements with entities they rate).

236. *Compare* Council Regulation 1060/2009, *supra* note 16 annex I, § C(4) (prohibiting analysts from receiving any gifts, money, or favors with anyone doing business with the CRA), *with* 17 C.F.R. § 240.17g-5(c)(7) (prohibiting analysts from receiving gifts or entertainment from someone associated with the rated entity, over an aggregate value of twenty-five dollars), *and* IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 2.15 (prohibiting analysts from receiving gifts or cash "exceeding a minimal monetary value" from anyone doing business with the CRA).

237. *Compare* 17 C.F.R. § 240.17g-5(c)(2) (prohibiting analysts from having direct ownership in the securities or other interests of the rated entity), *with* Council Regulation 1060/2009, *supra* note 16, annex I, § C(2)(a)–(c) (prohibiting interest in rated entities which may cause a general perception of a conflict of interest), *and* IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 2.13(a)–(e) (recommending that analysts with any relationship to the rated entity not participate in the rating).

238. *Compare* Credit Rating Reform Act of 2006, 15 U.S.C. § 78o-7(j) (2006) (requiring CRAs to designate a conflicts of interest compliance officer without specifying compensation restrictions), *with* Council Regulation 1060/2009, *supra* note 16, annex I, § A(5)–(7) (requiring a separate compensation structure for compliance officers to ensure independent judgments), *and* IOSCO, REVISED CODE

between the EU CRA Regulation, the revised IOSCO Code of Conduct, and the U.S. Rating Agency Act, there are slight nuances in many of the rules that could create a logistical nightmare for CRAs determining what conflicts of interest requirements to implement and enforce.[239]

C. METHODOLOGIES AND QUALITY OF CREDIT RATINGS

While all three regulatory regimes address the procedures and methodologies CRAs use to formulate credit ratings, only the EU CRA Regulation offers explicit details. The U.S. Rating Agency Act prohibits U.S. regulators at either the state or federal level from "regulat[ing] the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings."[240] As a result, other than a few disclosure requirements necessary for CRAs to register as NRSROs,[241] the U.S. rules and regulations governing NRSROs provide no requirements related to methodologies or rating procedures. The EU CRA Regulation does not contain a similar prohibition in the primary text of the regulation, but the recitals do state that the competent authorities and member states should not interfere in "relation to the substance of credit ratings and the methodologies by which a credit rating agency determines credit ratings."[242] Many CRAs have expressed concern, however, that this is insufficient to protect their independence.[243] The CRAs' fear of intrusion in the content of their rating opinions from EU regulators stems from two factors. First, the provisions in the EU CRA Regulation are broad enough to give regulators a wide range to interfere with the quality of ratings and methodologies, the information used to support ratings, and the judgment and

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OF CONDUCT, *supra* note 71, § 1.15.

239. *See supra* Part II.B.

240. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, § 4, 120 Stat. 1327 (amending 15 U.S.C. § 78o-7(c)(2)).

241. *See id.* (amending 15 U.S.C. § 78o-7(a)(1)(B)(i)–(ii)).

242. Council Regulation 1060/2009, *supra* note 16, para. 58.

243. *See* Letter from Stephen W. Joynt to European Comm'n, *supra* note 210, at 2 (recognizing that CRAs must have independence in formulating the content of their ratings); Letter from Michel Madelain to Maria Valentza, *supra* note 198, at i (arguing for regulatory flexibility so as to allow CRAs the freedom to develop methodologies and policies); Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 4 (stating that various regulatory provisions are too burdensome to ensure independent and objective ratings).

experience of CRA analysts and personnel.[244] Second, governments are the largest issuers of debt globally which could heighten sensitivities to potential ratings actions.[245] As a result, EU regulators could feel pressured into preventing CRAs from taking certain rating actions.[246] This particular concern is heightened by the fact that the EU CRA Regulation allows for regulators of the home member states to impose sanctions on CRAs.[247] Therefore, the manner in which a CRA can implement its methodologies and assess the quality of credit ratings is critical to ensuring CRA independence.

The EU CRA Regulation directs CRAs to only use "methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing."[248] Comparatively, the IOSCO Code of Conduct recommends that, where possible, ratings methods should be subject to some form of objective validation based on historical experience.[249] The EU CRA Regulation thus creates a requirement that CRAs validate their methodologies based on historical experience, rather than following the recommendation in the IOSCO Code of Conduct. This could result in CRAs being discouraged from developing new methods.[250] The EU CRA Regulation also inserts the additional requirement that the methodologies be "continuous," a description not included in the IOSCO Code of Conduct.[251] CRAs often use both quantitative and qualitative inputs in rating decisions, with analysts evaluating the relative importance of different inputs, and it is unclear if these are considered "continuous" or "systematic."[252] Moreover, this provision could justify regulatory interference in the methods, models, and independent rating decisions of CRAs

244. Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 4.

245. Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 1.

246. *Id.*

247. Council Regulation 1060/2009, *supra* note 16, art. 24(1)(a)–(c), (f) (allowing regulators to withdraw the registration of a CRA, temporarily prohibit a CRA from issuing a credit rating, prevent the Community from using the CRA's credit rating, or refer matters for criminal prosecution).

248. *Id.* art. 8(3).

249. IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 1.2.

250. *See* Letter from Stephen W. Joynt to European Comm'n, *supra* note 210, at 8 (arguing in opposition to article 12(4) of the Commission's proposed regulation (now article 8(3) of the current regulation) by stating that a standard regulatory review of rating methodologies is not suited to serve the development of new criteria).

251. Council Regulation 1060/2009, *supra* note 16, art. 8(3).

252. *See* HM TREASURY, *supra* note 164, at 18.

because it is not clear that independent judgment is protected.[253]

With regard to the methodologies used in relation to structured finance products, the EU CRA Regulation provides:

> In a case where the lack of reliable data or the complexity of the structure of a new type of financial instrument or the quality of information available is not satisfactory or raises serious questions as to whether a credit rating agency can provide a credible credit rating, the credit rating agency *shall* refrain from issuing a credit rating or withdraw an existing rating.[254]

The revised IOSCO Code of Conduct contains similar language, but only recommends that the CRA should update ratings when it is reasonable to do so; it does not mandate that the CRA necessarily withdraw a rating.[255] Whether the methodology of a particular credit rating meets the criteria of the EU CRA Regulation is a matter of interpretation and opinion.[256] This provision raises concerns that CRAs will be deterred from expressing views on more complex structures, which would not increase transparency. This provision is also potentially contrary to the best interest of the market as it is likely that investors value the opinion of an independent and experienced third party when they are making investment decisions for complex products.[257] If CRAs are prevented from publishing ratings in these circumstances, it may inhibit the movement of information in the markets and weaken investor confidence.[258] Most importantly, this provision appears to intrude on CRA independence, in direct violation of the U.S. Rating Agency Act's prohibition of regulating the substance, procedures, or methodologies used by CRAs. Constraining CRA independence in this way could even impair the credibility of the European capital market and disadvantage European issuers and investors in relation to their international counterparts, thereby

253. *Id.*

254. Council Regulation 1060/2009, *supra* note 16, annex I, § D I(4) (emphasis added).

255. IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 1.9(c).

256. Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, para. 4.5(e).

257. *Id.* para. 5.6; s*ee also* Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 2 (stating that CRAs may be prevented from publishing unpopular but candid and objective commentary on structured finance instruments when many investors value credit ratings precisely because they are independent, objective, and for the benefit of the market rather than any individual).

258. Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 2.

raising the cost of capital.[259]

The EU CRA Regulation additionally requires that the CRAs "adopt, implement and enforce adequate measures to ensure that the credit ratings it issues are based on a thorough analysis of all the information that is available to it" and also "adopt all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from reliable sources."[260] The IOSCO Code of Conduct, on the other hand, only suggests that CRAs adopt "reasonable measures so that the information it uses in assigning a rating is of sufficient quality to support a credible rating."[261] The EU CRA Regulation is viewed by CRAs as creating an unprecedented affirmative duty to conduct due diligence on all underlying information used in ratings.[262] This raises several concerns. First, if the EU interprets these verification regulations as making CRAs liable for the quality of the due diligence performed, it exposes the CRAs to legal liability.[263] Second, this could lead to greater reliance on credit ratings, contrary to the goal of the European Commission.[264] Third, there may be instances when conducting due diligence is not possible because it is prohibited by law, the information is unavailable for review, or there is such a large volume of information that it would be unworkable.[265] Given the hundreds of thousands of ratings some CRAs assign globally, obligating a CRA to verify all underlying information used in a rating would be overly burdensome and could potentially bring operations to a halt.[266] Finally, this requirement is inconsistent with the fundamental role CRAs play in the financial markets.[267]

The EU CRA Regulation also requires CRAs to review their credit ratings and methodologies at least annually.[268] The revised IOSCO Code of Conduct, on the other hand, only states that CRAs should establish a review function responsible for periodically reviewing the methodologies in such a manner that

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259. *Id.*
260. Council Regulation 1060/2009, *supra* note 16, art. 8(2).
261. IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 1.7.
262. Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 7.
263. *See, e.g.*, Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, para. 9.2.
264. *See* Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 20.
265. *Id.* at 7 n.19.
266. *Id.* at 19–20.
267. Letter from Larry G. Mayewski to European Comm'n, *supra* note 202, at 6.
268. Council Regulation 1060/2009, *supra* note 16, art. 8(5).

is "consistent with the applicable rating methodology."[269] Requiring CRAs to review their methods annually encourages a one-size-fits-all depth of review that could result in wasting resources on reviews of uncontroversial methods which already produce a stable rating performance.[270] This also raises a concern about the U.S. Rating Agency Act's prohibition on regulating the procedures or methodologies used in determining ratings.[271]

Additionally, the EU CRA Regulation requires that when a methodology, model, or key rating assumption changes, the CRA must immediately disclose the change and the likely scope of the credit ratings affected, review the affected credit ratings within six months of the change, and re-rate all ratings affected by the changed methodologies.[272] The IOSCO Code of Conduct only recommends that CRAs publicly disclose material modifications to its methodologies, and does not contain any provisions suggesting that CRAs review and re-rate previously issued credit ratings.[273] Because CRAs must review all affected credit ratings within a fixed time of six months after the change, this could significantly deter CRAs from undertaking major alterations to methodologies if it is unclear that the review can be completed within the allotted time frame.[274] Furthermore, requiring CRAs to disclose the scope of credit ratings likely to be implicated could generate market volatility. If a CRA is required to indicate the potential direction of a rating immediately following a methodological change without having yet done a thorough analysis and review, the market could overreact.[275]

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269. IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 1.9(b).

270. Letter from Stephen W. Joynt to European Comm'n, *supra* note 210, at 8 (responding to article 12(4) of the Commission's proposed regulations (now article 8(5) of the current regulation)); *see also* Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 23 (arguing that codifying a timeline would be inappropriate since it may be necessary to conduct more or less frequent reviews).

271. Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, ¶ 10.1 (encouraging the Commission to align its regulations with the SEC Rules concerning the practice of CRAs relying on existing ratings from other CRAs).

272. Council Regulation 1060/2009, *supra* note 16, art. 8(6).

273. IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 3.10.

274. Letter from Stephen W. Joynt to European Comm'n, *supra* note 210, at 8–9 (responding to article 12(5) of the Commission's proposed regulations (now article 8(6) of the current regulation)).

275. Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 22; s*ee also* HM TREASURY, *supra* note 164, at 20 (arguing that an enforced re-rating of securities that are meeting original expectations could send out misleading messages and create unnecessary costs in the market).

D. DISCLOSURE AND TRANSPARENCY

Both the U.S. and EU regulations contain detailed provisions pertaining to disclosure and transparency, but the disclosures required by the EU CRA Regulation are more far-reaching than those required by the U.S. Rating Agency Act. Both require, among other things, the disclosure of conflicts of interest,[276] organizational structure,[277] codes of conduct,[278] a list of the largest twenty clients by revenue,[279] and methodologies.[280] The EU CRA Regulation additionally requires disclosure of the general nature of compensation arrangements,[281] material modifications made to systems, resources and procedures,[282] a list of all ancillary services provided by the CRA,[283] as well as disclosure of various policies.[284] While perhaps burdensome, these added disclosures do not create any specific hurdles for CRAs, considering the revised IOSCO Code of Conduct already recommends CRAs make many of these disclosures,[285] and the U.S. regulation requires CRAs to maintain records pertaining to many of these

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276. *Compare* Council Regulation 1060/2009, *supra* note 16, annex I, § E(I)(1), *with* 15 U.S.C. § 78o-7(a)(1)(B)(vi) (2006).

277. *Compare* Council Regulation 1060/2009, *supra* note 16, annex I, § E(III)(1), *with* 15 U.S.C. § 78o-7(a)(1)(B)(iv) (2006).

278. *Compare* Council Regulation 1060/2009, *supra* note 16, annex I, § E(I)(7), *with* 15 U.S.C. § 78o-7(a)(1)(B)(v) (2006).

279. *Compare* Council Regulation 1060/2009, *supra* note 16, annex I, § E(II)(2)(a) (requiring such information be made public), *with* 15 U.S.C. § 78o-7(a)(1)(B)(viii) (2006) (allowing such information to be kept confidential). The EU CRA Regulation also requires CRAs disclose a list of clients

> [w]hose contribution to the growth rate in the generation of revenue of the credit rating agency in the previous financial year exceeded the growth rate in the total revenues of the credit rating agency in that year by a factor of more than 1.5 times. Any such client shall be included on the list only where, in that year, it accounted for more than 0.25% of the worldwide total revenues of the credit rating agency at global level.

Council Regulation 1060/2009, *supra* note 16, annex I, § E(II)(2)(b).

280. *Compare* Council Regulation 1060/2009, *supra* note 16, annex I, § E(I)(5), *with* 15 U.S.C. § 78o-7(a)(1)(B)(iii) (2006).

281. Council Regulation 1060/2009, *supra* note 16, annex I, § E(I)(4).

282. *Id.* annex I, § E(I)(6).

283. *Id.* annex I, § E(I)(2).

284. *See id.* annex I, § E(I)(3) (requiring disclosure of the policy concerning publication of credit ratings); *id.* annex I, § E(III)(4) (requiring disclosure of the record-keeping policy); *id.* annex I, § E(III)(6) (requiring disclosure of the management and rating analyst rotation policy).

285. *See* IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 2.8 (compensation arrangements); *id.* § 3.3 (rating presentation policy); *id.* § 3.9 (unsolicited rating policy); *id.* § 3.10 (material modifications).

items.[286]

In addition to the disclosure of methodologies required by both the U.S. and EU regulations, the EU CRA Regulation requires CRAs to publicly disclose "descriptions of models and key rating assumptions such as mathematical or correlation assumptions used in its credit rating activities."[287] Moody's raised concerns that this places too much weight on models and could lead users of ratings to discount the significance of qualitative factors, mistakenly treat credit opinions as statements of fact, or view deviations from models as evidence of a CRA's failure to follow procedure.[288] Moreover, rating analysts and ratings committees might be discouraged from exercising their independent judgment, which could in turn negatively affect the quality and usefulness of credit ratings altogether.[289]

The EU and U.S. regulations also differ on the extent to which CRAs must disclose credit ratings. The EU CRA Regulation requires CRAs to "disclose any credit rating, as well as any decision to discontinue a credit rating, on a non-selective basis and in a timely manner," including credit ratings that are distributed by subscription.[290] The U.S. only requires CRAs to make all credit ratings available either twelve or twenty-four months after the rating action is taken,[291] with a random sample of 10% of the outstanding issuer-paid credit ratings for each class of credit ratings for which it has issued 500 or more outstanding credit ratings made publicly available six months after the rating action is taken.[292]

The SEC believes that this amount of disclosure is sufficient because it should result in a substantial amount of new information and allow market observers to analyze the

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286. *See* 17 C.F.R. § 240.17g-2(a) (2009) (effective Feb. 1, 2010) (requiring, among other things, that CRAs maintain records on the identity of any credit analyst(s) that participated in determining the rating, the identity of the person that approved the rating, any rationale for a material difference between the rating implied by the model and the final rating issued, whether a rating was solicited or unsolicited, a list of the general types of services and products offered, and compliance reports).

287. Council Regulation 1060/2009, *supra* note 16, annex I, § E(I)(5).

288. Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 26.

289. *Id.*

290. Council Regulation 1060/2009, *supra* note 16, art. 10(1).

291. *See* 17 C.F.R. §§ 240.17g-2(d)(3)(i)(B), (C) (2009) (effective Feb. 1, 2010) (requiring disclosure of all obligor paid ratings twelve months after rating release and disclosure of non-obligor paid ratings twenty-four months after rating release).

292. *Id.* § 240.17g-2(d)(2) (requiring information to be made publicly available on the CRAs' websites).

information and develop performance metrics.[293] The EU CRA Regulation's complete public disclosure requirement of all credit ratings, both issuer and subscriber paid, could reduce competition and have an adverse impact on CRAs that make money from selling ratings.[294] Instead, the SEC argues that the level of disclosure called for in the U.S. regulations will likely enhance competition by making it easier for smaller CRAs to establish a proven track record of determining accurate ratings.[295]

In an attempt to make the rating process more transparent, the EU CRA Regulation requires CRAs to make historical performance data available in a central repository established by CESR.[296] This data is required for all credit ratings "(i) issued or endorsed by credit rating agencies registered in the Community, or (ii) issued by any certified credit rating agency which are disclosed publicly or distributed by subscription," but preferably for all credit ratings issued globally.[297] CESR requested that CRAs submit historical rating performance data covering at least the previous ten years before the regulation took force.[298] Many CRAs have objected to free access to historical data because such information is currently available only to paid subscribers.[299] CESR, however, has yet to put any

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293. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342, 74 Fed. Reg. 6456, 6460 (Feb. 9, 2009) (to be codified at 17 C.F.R. pts. 240 and 249b).

294. *Id.* at 6461.

295. *Id.* at 22.

296. Council Regulation 1060/2009, *supra* note 16, art. 11(2) (requiring disclosure of historical performance data "including the ratings transition frequency and information about credit ratings issued in the past and on their changes"). The CRAs can supply CESR with raw data and CESR will compile the performance statistics itself. CESR, *Feedback Statement: CESR's Consultation on CRAs Central Repository*, ¶ 9, CESR/09-822a, (Oct. 21, 2009), *available at* http://www.cesr-eu.org/popup2.php?id=6143 [hereinafter CESR, *Feedback Statement*].

297. CESR, *Feedback Statement*, *supra* note 296, ¶ 11. Reporting must be consistent across all asset classes and an explanation is required if a non-global approach is taken. *Id.* ¶ 15.

298. *See* CESR, *Consultation Document: CRAs Central Repository*, ¶ 66, CESR/09-579, (July 9, 2009), *available at* http://www.cesr-eu.org/popup2.php?id=5795 [hereinafter CESR, *Consultation Document*]. Both Moody's and S&P are unclear about the time frame for historic data desired by CESR. *See* Letter from Federic Drevon, Senior Managing Dir., Moody's Investors Serv., to Comm. of Sec. Regulators, 8 (Aug. 7, 2009), *available at* http://www.cesr-eu.org/popup_responses.php?id=4783; Standard & Poor's Ratings Services, Response Dated 7 August 2009 to CESR Consultation Paper on CRA Central Repository, 3 (Aug. 7, 2009), *available at* http://www.cesr-eu.org/popup_responses.php?id=4787.

299. *See* Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 37

measures in place to address those concerns.[300]

The EU CRA Regulation also contains substantial disclosure requirements pertaining to the presentation of ratings.[301] CRAs are required to state the names and titles of the lead rating analysts and primary person responsible for approving the rating,[302] to indicate the material sources which were used to prepare the credit rating,[303] to state the methodology used to determine the rating,[304] to provide appropriate risk warnings, and to state any attributes and limitations of the rating.[305] The extensive presentation requirements are extremely burdensome on CRAs because each rating reflects opinions based on large amounts of information from numerous sources,[306] all of which would need to be disclosed in order to provide a complete understanding of the rating. Furthermore, the regulation is vague, failing to provide any guidance on what is meant by phrases like "sensitivity analysis of the relevant assumptions."[307] These provisions seem aimed at curtailing investors' excessive reliance on credit ratings by helping them understand the risks associated with the rated product or entity, but unless investors recognize that ratings only reflect credit risk, even these detailed disclosure requirements will do nothing to stop over-reliance on ratings.[308]

Finally, CRAs are required by the EU CRA Regulation to file an annual transparency report which includes a description of the internal control mechanisms, statistics on the allocation of staff, a description of its record-keeping policy, and the outcome of an annual internal review of the independence compliance function.[309] This essentially creates an entirely new disclosure system that is inconsistent with existing global norms

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(raising additional concerns that third parties could reformat the data and present it as their own); s*ee also* Letter from Stephen W. Joynt to European Comm'n, *supra* note 210, at 9; Letter from Larry G. Mayewski to European Comm'n, *supra* note 202, at 4.

300. *See generally* CESR, *Consultation Document*, *supra* note 298.

301. *See* Council Regulation 1060/2009, *supra* note 16, art. 10; *id.* annex I, § D.

302. *Id.* annex I, § D(I)(1).

303. *Id.* annex I, § D(I)(2)(a).

304. *Id.* annex I, § D(I)(2)(b).

305. *Id.* annex I, § D(I)(4) (requiring CRAs to disclose whether it considers the information available on the rated entity satisfactory and to what extent the CRA has verified information provided to it by the rated entity).

306. Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 42.

307. *Id.*

308. *See* HM TREASURY, *supra* note 164, at 14.

309. *See* Council Regulation 1060/2009, *supra* note 16, art. 12, annex I, § E(III).

and standards.[310] Moody's expressed specific concern that the disclosure requirements could have a chilling effect on internal compliance and discourage potential whistleblowers from reporting concerns.[311] Despite these and other concerns, CESR has yet to issue any guidance as to how the transparency report requirements will be interpreted.

E. STRUCTURED FINANCE INSTRUMENTS

Regulators reacted to the heavy criticism of CRAs' ratings of structured finance instruments by enacting specific provisions aimed directly at solving the problems brought to light by the subprime mortgage crisis.[312] Unlike traditional corporate bond ratings, credit ratings of structured finance products are often viewed as seals of approval, which raises regulatory concerns given that CRAs generally do not confirm the validity of the underlying data provided to them.[313] The EU CRA Regulation addresses this by requiring CRAs to "state what level of assessment it has performed concerning the due diligence processes carried out at the level of underlying financial instruments or other assets of structured finance instruments."[314]

The EU CRA Regulation also requires CRAs to explain the "assumptions, parameters, limits and uncertainties surrounding the models and rating methodologies used in [structured finance] credit ratings, including simulations of stress scenarios undertaken by the agencies when establishing the ratings."[315] The revised IOSCO Code of Conduct contains a similar provision, asking a CRA to "disclose the degree to which it analyzes how sensitive a rating of a structured finance product is to changes in the CRA's underlying rating assumptions."[316] Additionally, both the revised IOSCO Code of Conduct and the EU CRA Regulation contain provisions requiring CRAs to

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310. Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 28.

311. *Id.*

312. *See generally* FIN. STABILITY FORUM, *supra* note 68 (providing recommendations such as implementing the Basel II capital framework); IOSCO, FINAL REPORT, *supra* note 70 (recommending a Code of Conduct focused on maintaining the quality of the ratings process, the independence of rating agencies, and CRAs' responsibilities to the investing public).

313. IOSCO, FINAL REPORT, *supra* note 70, at 8.

314. Council Regulation 1060/2009, *supra* note 16, annex I, § D(II)(2).

315. *Id.* annex I, § D(II)(3).

316. IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 3.5(a).

provide information about the loss and cash flow analysis it has performed or upon which it is relying.[317] These provisions are aimed at addressing regulators' concerns about a lack of independent means by which institutional investors can assess the risk of the securities.[318]

The revised IOSCO Code of Conduct, EU CRA Regulation, and recent amendments to the rules promulgated pursuant to the U.S. Rating Agency Act all contain provisions aimed at promoting unsolicited ratings of structured finance products, thereby reducing "rating shopping."[319] The EU addresses this problem by requiring CRAs to disclose information about all structured finance products submitted for initial review or preliminary rating, regardless of whether issuers contract with the CRA for a final rating.[320] The revised IOSCO Code of Conduct and the U.S. rules take a slightly different approach by requiring structured finance issuers to publicly disclose all information provided to the CRAs for use in determining the credit rating,[321] an approach supported by the CRAs.[322]

The U.S. regulation addresses the problem of rating shopping by first making it a conflict of interest for a CRA to provide a rating of any structured finance instrument paid for by the issuer, sponsor, or underwriter.[323] A CRA is then prohibited from having a conflict of interest unless certain requirements are met. First, the CRA must maintain a password-protected website listing every structured finance instrument for which the CRA is currently in the process of determining an initial credit rating.[324] Next, the CRA must provide other CRAs with unlimited access to this password-protected website so long as the CRAs meet certain certification

317. Council Regulation 1060/2009, *supra* note 16, annex I, § D(II)(1); IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 3.5(a).

318. *See* IOSCO, FINAL REPORT, *supra* note 70, at 9.

319. Rating shopping refers to CRAs being pressured into providing favorable ratings by asking different CRAs to provide prospective assessments of structured finance instruments before deciding which CRA to hire. *See id.* at 14.

320. Council Regulation 1060/2009, *supra* note 16, annex 1 § D(II)(4).

321. *See* 17 C.F.R. § 240.17g-5(a)(3) (2009) (effective Feb. 1, 2010); IOSCO, REVISED CODE OF CONDUCT, *supra* note 71, § 2.8(c).

322. *See, e.g.*, Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 30.

323. 17 C.F.R. § 240.17g-5(b)(9) (2009) (effective Feb. 1, 2010).

324. *Id.* § 240.17g-5(a)(3)(i). This list must be in chronological order and must identify the type of structured finance instrument, provide the name of the issuer, provide the date the rating process was initiated, and provide the website address where the issuer will disclose its required information. *Id.*

requirements.[325] The hired CRA must then obtain a representation from the arranger of the structured finance instrument that the arranger will contemporaneously post on its own password-protected website for all certified CRAs to access[326] all the information it provides the hired CRA for purposes of determining the initial credit rating[327] or for purposes of undertaking credit rating surveillance.[328] This includes information about the characteristics of the underlying assets, the legal structure of the instrument, and the performance of the assets.[329] The hired CRA is provided some safe harbor if the arranger fails to comply with its disclosure requirements so long as the CRA reasonably relied on the arranger's representation, taking into consideration factors such as prior failures by the arranger to adhere to its representations.[330]

By requiring arrangers to make all the information given to retained CRAs available to all other CRAs, the U.S. regulation will improve the quality of credit ratings for structured finance products by making it possible for more CRAs to rate these instruments.[331] The dissemination of these unsolicited ratings should then make it more difficult for arrangers to engage in rating shopping because the market will reveal ratings issued higher than warranted.[332] At the same time, the requirements are not excessively burdensome on CRAs as they are only required to maintain minimal information on pending deals.[333]

The only significant difference between the EU and U.S. regulations as they pertain to ratings of structured finance instruments is in the use of rating symbols. The EU CRA

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325. *See Id.* § 240.17g-5(a)(3)(ii). In order to be certified the CRA must state, among other things, that the CRA will determine and maintain ratings for at least 10% of the structured finance instruments for which it accesses information if it accesses information for ten or more issued securities in the calendar year covered by the certification. *See id.* § 240.17g-5(e).

326. *See id.* § 240.17g-5(a)(3)(iii)(B).

327. *Id.* § 240.17g-5(a)(3)(iii)(C).

328. *Id.* § 240.17g-5(a)(3)(iii)(D).

329. *Id.* § 240.17g-5(a)(3)(iii)(C), (D).

330. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-61050, 74 Fed. Reg. 63,832, 63,847 (Dec. 4, 2009) (to be codified at 17 C.F.R. pts. 240 and 249b).

331. *See id.* at 63,851.

332. *Id.*

333. *Id.* at 63,854 (arguing that adding a portal for other CRAs to access pending deal information is not expected to require significant costs as all CRAs currently maintain websites with password-protected portals).

Regulation requires CRAs to differentiate credit ratings for structured finance instruments from traditional corporate debt instruments by using an additional symbol.[334] Many CRAs objected to this requirement for various reasons.[335] First, the rule directly contradicts strong investor sentiment, with over 75% of investors surveyed by Moody's strongly advising against changing the rating scale currently used.[336] Many investors also expressed the view that simply adding a modifier for structured finance ratings would be a purely cosmetic change.[337] Moreover, CRAs disapprove of the requirement because of the significant market costs involved in implementing changes in the rating symbols.[338] From a practical perspective, there is no universally accepted definition of the term "structured finance," making it difficult for CRAs to determine exactly which instruments require the additional symbol.[339] It is also unlikely that the added symbol will adequately address investor's misunderstandings about the risks associated with these products.[340] Finally, and most importantly, the EU CRA Regulation creates significant international divergence in an area which had previously been consistent worldwide.

F. OVERARCHING IMPLICATIONS OF THE EU CRA REGULATION

While individually every requirement in the EU CRA Regulation appears to be reasonable and have a positive effect on the quality of ratings issued by CRAs, taken as a whole the requirements are over-burdensome, anti-competitive, and effectively export the EU's regulatory regime to any country which headquarters a CRA wishing to issue ratings for use in

334. Council Regulation 1060/2009, *supra* note 16, art. 10(3).

335. *See* Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 3; Letter from Stephen W. Joynt to European Comm'n, *supra* note 210, at 9; Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 6–7.

336. Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 24 (surveying over 200 institutions representing over $9 trillion in fixed income assets under management).

337. *See id.*; Letter from Stephen W. Joynt to European Comm'n, *supra* note 210, at 9.

338. *See* HM TREASURY, *supra* note 164, at 13; Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 24.

339. Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 24 (arguing that covered bonds, hybrid debt securities, trust preferred securities, warrants, and convertible bonds could be construed as forms of structured financing and fall within the requirement).

340. *See id.*; HM TREASURY, *supra* note 164, at 21.

the EU. The EU CRA Regulation essentially ignores the fact that most CRAs are headquartered outside of the EU and therefore subject to various laws and regulations in their home country which do not conform to the detailed standards promulgated by the European Commission.[341]

The extent of the extraterritorial and anti-competitive effects of the EU CRA Regulation turn on a few issues which have yet to be resolved. First, what does "systemically important" mean?[342] If this term is defined too broadly, some of the affected CRAs may decline to establish a subsidiary within the EU as required by the endorsement provisions[343] due to the large costs associated with such a venture.[344] Second, what will happen if a credit rating agency or non-EU regulator cannot fulfill its obligations under the EU CRA Regulation because it is illegal in its host country? For example, many CRAs expressed concern that the corporate governance requirements intruded on shareholder rights or established standards in their home country, and it is thus likely that they could not comply with many of the EU's requirements without violating a separate law.[345] It seems unlikely that a non-EU regulator would alter its shareholder rights laws simply so that a few CRAs could comply with the EU CRA Regulation. Similar concerns were also raised in the context of the employment restrictions placed on analysts.[346]

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341. *See* Letter from Vickie A. Tillman to DG MARKT, *supra* note 164, at 3.

342. The Financial Stability Board has issued a report providing guidance for national authorities on how to assess the systemic importance of financial institutions, markets, and instruments. *See* INT'L MONETARY FUND, BANK FOR INT'L SETTLEMENTS & FIN. STABILITY BD., GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS AND INSTRUMENTS: INITIAL CONSIDERATIONS (Oct. 28, 2009), http://www.financialstabilityboard.org/publications/r_091107c.pdf (outlining conceptual and analytical approaches to the assessment of systemic importance and discussing a possible form for general guidelines).

343. *See* Council Regulation 1060/2009, *supra* note 16, art. 4(3).

344. *See* Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 2; Letter from Yasuhiro Harada to Jörgen Holmquist, *supra* note 179, at 4.

345. *See* Letter from Takefumi Emori to the European Comm'n, *supra* note 183, at 3 (explaining that term limits for non-executive board members could be found to be an excessive intrusion into the rights of shareholders); Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 3 (stating that Moody's complies with the New York Stock Exchange's Corporate Governance Listing Standards, which differ from the EU CRA Regulation's corporate governance standard).

346. *See generally* Letter from Yasuhiro Harada to Jörgen Holmquist, *supra* note 179, at 18; HM TREASURY, *supra* note 164, at 23; Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 5.

The most pressing issue is how strictly the European regulators will make equivalency determinations. While it seems probable that exceptions could be made regarding corporate governance and disclosure requirements, it seems unlikely that the U.S. regulatory regime would be deemed equivalent in terms of rating methodologies and the quality of ratings given the significance EU regulators placed on these provisions. Specifically, because the United States prohibits regulators from interfering with the substance of ratings, or the procedures and methodologies used to determine ratings,[347] many of the requirements in the EU CRA Regulation would not be deemed legal in the United States.[348] If this is in fact the case, U.S. regulators could not adopt these requirements in order to meet the EU's equivalence requirements without first repealing the prohibition. The extraterritorial reach of the EU CRA Regulation in such a situation is extreme, forcing U.S. regulators to choose either to limit CRAs based in the United States who desire to issue ratings for use in the EU to the endorsement requirements, or to adopt provisions contrary to a key philosophy underlying its regulation of CRAs.

G. SOLUTIONS: THE NEED FOR MUTUAL RECOGNITION AND BILATERAL DIALOGUES

Any potential extraterritorial and anti-competitive effects of the EU CRA Regulation could be substantially reduced if the European Union adopted an equivalency decision for the United States and Japan without forcing either country to implement the EU CRA Regulation in full. Because the regulations in the United States are essentially designed to achieve the same ultimate goals as the EU CRA Regulation,[349] European

347. *See* Credit Rating Reform Act of 2006, 15 U.S.C. § 78o(c)(2) (2006).

348. *See* Letter from Michel Madelain to Maria Valentza, *supra* note 198, at 1–2 (raising concerns that many of the provisions intrude on CRA independence and could lead CRAs to be discouraged or prevented from publishing candid and objective ratings).

349. *Compare* Commission of the European Communities, *Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies*, at 4, COM (2008) 704 final (Nov. 12, 2008), http://ec.europa.eu/internal_market/securities/docs/agencies/proposal_en.pdf (listing avoidance of conflicts of interest, improving the quality of the methodologies, increasing transparency, and ensuring efficient registration and surveillance as the four primary objectives of the legislation), *with* Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342, 74 Fed. Reg. 6456 (Feb. 2, 2009) (to be codified at 17 C.F.R. pts. 240 and 249b) (listing

regulators should deem the U.S. regulations equivalent to the EU regulation despite differences in the means used to achieve those goals, as was the case when the EU made prior equivalency determinations regarding financial reporting standards.[350] The adoption of an equivalency determination is particularly important if the "at least as stringent" requirement in the endorsement provisions can only be met when the home country is deemed equivalent.[351] If this is in fact how the regulation is interpreted, then any CRA whose home country is not deemed equivalent would be unable to make its ratings available for use in the European Union without establishing an affiliate in the EU, registering that entity, and conducting one hundred percent of its ratings activity in the European Union.[352] Such a conclusion could have a catastrophic impact on the financial markets in the European Union if non-EU based CRAs were unwilling to conduct all of their European rating activities in the EU.

The most effective way to minimize potential regulatory gaps and address the regulatory frictions resulting from differing regulatory regimes is through international coordination and bilateral dialogues.[353] Regulators in the U.S., EU, and around the globe should continue to work together toward the goals outlined by the G-20, achieving an "oversight framework . . . consistent across jurisdictions with appropriate sharing of information between national authorities, including through IOSCO."[354] Pursuant to these initiatives, "IOSCO has

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increasing transparency, strengthening disclosure of ratings performances, prohibiting certain conflicts of interest, and enhancing recordkeeping and reporting obligations as the primary goals of the rule amendments).

350. *See* Council Directive 2008/961, Commission Decision of 12 December 2008 on the Use By Third Countries' Issuers of Securities of Certain Third Country's National Accounting Standards and International Financial Reporting Standards to Prepare Their Consolidated Financial Statements, 2008 O.J. (L 340) 112 (EC) (deeming the U.S. and Japanese Generally Accepted Accounting Principles equivalent to the EU's International Financial Reporting Standards despite significant differences).

351. *See* CESR, *Call for Evidence*, *supra* note 141, at 21 (arguing that the "at least as stringent" requirement for endorsement is the same as the equivalency determination required for certification).

352. *See* Council Regulation 1060/2009, *supra* note 16, art. 4(3)–(5).

353. *See* Kathleen L. Casey, Comm'r U.S. Securities and Exchange Comm'n, Testimony Concerning International Cooperation to Modernize Financial Regulation, Before the U.S. S. Banking Subcomm. on Sec. and Int'l Trade and Fin. (Sept. 30, 2009), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=a3381afe-030b-4c16-97df-d4b3e6d01c96.

354. U.S. CHAIR OF THE PITTSBURGH G-20 SUMMIT, PROGRESS REPORT ON THE

commenced a dialogue with CRAs and is examining whether differences in the implementation of national and regional regulatory frameworks . . . present compliance problems or arbitrage opportunities."[355] IOSCO is additionally conducting a regular dialogue between regulators and the CRAs regarding any implementation problems from the industry's perspective.[356] It is crucial that CRAs and regulators continue to work together through IOSCO to ensure the regulatory system put in place meets the needs of investors and regulators alike.

In particular, it is important the U.S. and EU work together through the U.S.-EU Financial Markets Regulatory Dialogue to ensure that equivalence determinations for CRAs follow an outcomes-based assessment rather than requiring an exact duplication of rules.[357] This dialogue has been successful in the past, and members from both the U.S. and EU should use this forum yet again to ensure that the regulations are as compatible and as convergent as possible.[358] Finally, CESR and the SEC should put together a plan as quickly as possible to guide the SEC-CESR dialogue in the immediate future to ensure the regulation of CRAs is globally consistent.[359]

CONCLUSION

In less than a decade, credit rating agencies have gone from self-regulated entities virtually ignored by regulators to entities subject to detailed regulatory regimes in both the United States and the EU. Spurred by issues which came to light due to the subprime mortgage crisis, regulators in both the EU and United States are seeking to regulate CRAs in order to increase

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ACTIONS TO PROMOTE FINANCIAL REGULATORY REFORM 19 (Sept. 25, 2009), *available at* http://www.g20.org/Documents/pittsburgh_progress_report_250909.pdf.

355. FINANCIAL STABILITY BOARD, PROGRESS SINCE THE PITTSBURGH SUMMIT IN IMPLEMENTING THE G20 RECOMMENDATIONS FOR STRENGTHENING FINANCIAL STABILITY 12 (Nov. 7, 2009), *available at* https://www.financialstabilityboard.org/publications/r_091107a.pdf.

356. *Id.* at 12–13.

357. TRANSATLANTIC ECONOMIC COUNCIL, JOINT REPORT ON U.S. – EU FINANCIAL MARKETS REGULATORY DIALOGUE FOR THE TEC MEETING 1–2 (Oct. 27, 2009), http://ec.europa.eu/enterprise/policies/international/files/joint_report_on_fmrd_en.pdf (stating that U.S. and EU regulators are working together regarding equivalence).

358. *Id.* at 1.

359. *See, e.g.*, Press Release, Sec. & Exch. Comm'n, SEC and CESR Launch Work Plan Focused on Financial Reporting (Aug. 2, 2006), http://www.sec.gov/news/press/2006/2006-130.htm (describing actions previously taken by the SEC and CESR to coordinate regulation of international accounting principles).

transparency, strengthen disclosure, avoid conflicts of interest, and generally improve the quality of ratings to ensure that the problems highlighted by the recent financial turmoil are avoided in the future. While the goals are the same, the EU's regulatory regime takes a much more prescriptive approach to regulation than both the IOSCO Code of Conduct and the U.S. Rating Agency Act, outlining detailed requirements pertaining to corporate governance and rating methodologies.

The EU's divergence from the international regulatory consensus, as reflected in the IOSCO Code of Conduct, would not be as significant if the EU CRA Regulation did not mandate that the regulatory regimes of non-EU CRAs must be deemed equivalent in order for such non-EU CRAs to issue credit ratings for use in the European Union. The EU now has the upper-hand when it comes to regulation of international credit rating agencies as it decides whether the standards set in other jurisdictions are sufficient. As a result, even where EU and U.S. regulations do not currently conflict, the SEC may face pressure not to adopt new rules for fear of creating conflicts with the EU regulations that could potentially harm U.S. rating agencies operating in Europe. It is thus essential that regulators work together through bilateral dialogues to ensure that the various regulations are compatible to eliminate the potential adverse cross-border impact different regulatory approaches may have on global market participants.