Regulating credit rating agencies – the new United States and European Union law – important steps or much ado about nothing?

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1 *Instruments of capital market law and the financial crisis*

1.1 Background information on the financial crisis

An agenda of stricter regulation of the financial sector was asserted by federal chancellor Merkel and French president Sarkozy at the recent G20 summit in London. By some, this was celebrated as a historic date, whereas others remained more sceptical, as general resolutions are no substitute for a concrete legislative framework. What this view fails to realise, however, is that in recent months the regulation of credit rating agencies has been comprehensively improved. This development is of particular importance because the legislature is now acting quickly and is no longer leaving it to private organisations to set their own standards. The new regulatory frameworks at the international, United States and European levels exceed the scope of their predecessors. Are these new legislative regimes the long hoped for corner-stones of a new financial market architecture, or are we simply dealing with a matter of legislative activism?

The global economy is currently experiencing its worst crisis since the 1930s. In recent years, capital markets were highly praised for their efficiency – thanks to modern technology it takes but a few mouse clicks to allocate investment capital where it can work most efficiently.[1] The harmonisation of capital market law thus promised great growth.[2] Unfortunately, something must have gone wrong.

The financial crisis has multiple causes: Many credit institutions did not observe established standards when granting loans. Especially in the United States, it was not uncommon to grant loans without requiring any proof of income. Mortgage

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1 Benicke *Wertpapiervermögensverwaltung* (2006) 91; Assmann and Schütz (eds) *Handbuch des Kapitalanlagerechts* (1997) commentary to §1 (24); Kübler *Gesellschaftsrecht* (1998) 390 § 31.II *et seq*. On the role of efficiency in capital market law in general see *eg* Hazen *The Law of Securities Regulation* (2006) 6; Coffee "Market failure and the economic case for a mandatory disclosure system" 1984 *Viginia Law Review* 717, 751; Drukarczyk *Theorie und Politik der Finanzierung* (1993) 84; Möllers "Creating standards in a global financial market, the Sarbanes-Oxley and other acts – what Europeans and Americans could, and should, learn from each other" 2007 *European Company and Financial Law Review* 173; Möllers "Efficiency as a standard in capital market law – the application of empirical and economic arguments for the justification of civil, criminal and administrative law sanctions" 2009 *European Business Law Review* 243.

2 Attachment 1 of Commission (EC) "Financial Service Policy 2005-2010" (Green Paper) COM (177) 4 final, 5 March 2005; The Committee of Wise Men "Final report of the committee of wise men regarding the regulation of the European securities market" (Final Report of 15 Feb 2001) 14 http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf (6-01-2009); European Central Bank "The Euro equity markets" (Aug 2001) 44 http://www.ecb.int/pub/pdf/other/euroequitymarketen.pdf (6-01-2009); Bundesverband deutscher Banken "Argumente zum Finanzmarkt: Fortsetzung der Integration der europäischen Finanzdienstleistungsmärkte" (March 2004) http://www.bankenverband.de/pic/artikelpic/032004/br0403_vw_azf_eudl_dt.pdf (6-01-2009).

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companies became more and more creative and offered such exotic loans as interest-only mortgages or payment option loans with negative amortisation, which attracted customers with low initial payments. Investment banks purchased these loans, pooled them and sold them as structured finance products called mortgage-backed securities, in particular residential mortgage-backed securities, or – repackaged – as collateralised debt obligations to investors from around the world. Since the risky loans quickly disappeared from the granting banks' balance sheets in this process, banks no longer had sufficient incentive to adhere to strict guidelines for granting loans – in particular, regarding potential customers' creditworthiness.[3]

1.2 Rating agencies as a structural problem?

What role did credit rating agencies play in this? Rating agencies are independent third parties in a financial market transaction. They are consulted to overcome asymmetric information between different parts of the market, which means that they provide some sort of balance for the differences in quality and quantity of information. As so-called information intermediaries they provide information to the investor at a cost lower than the investor's own investigation.[4] In order to do so, they evaluate financial claims according to standardised quality categories. Credit rating agencies certify the credit risk of company debt by standard quality categories. Globally, two major agencies, Standard & Poor's and Moody's dominate the market, followed by Fitch, which is significantly smaller.[5] Such an oligopolistic market developed because companies choose credit rating agencies by reputation.[6] Credit rating agencies stress that their ratings are nothing more than their subjective opinion, and do not guarantee performance.[7] The accuracy of ratings is judged on the basis of a detailed long-term protocol, the so-called track record. Analysis of the track record shows whether a credit rating agency has provided correct assessments over a prolonged period of time.[8]

[3] Bundesanstalt für Finanzdienstleistungsaufsicht *Jahresbericht 2007* (2008) 15. Regarding moral hazard see *eg* Shavell "On moral hazard and insurance" 1979 *QJ Econ* 541; Holmström "Moral hazard and observability" 1979 *Bell J Econ* 74.

[4] Pinto "Control and responsibility of credit rating agencies in the United States" 2006 *Am J Comp L* 341; Dittrich *The Credit Rating Industry: Competition and Regulation* (2007) 9.

[5] Standard & Poor's and Moody's share 80% of the market, and the British credit rating agency Fitch another 15%. See Hill "Regulating the rating agencies" 2004 *Washington Univ Law Quaterly* (*Wash ULQ*) 43 59; Blaurock "Verantwortlichkeit von Ratingagenturen" 2007 *ZGR* 603 606.

[6] Partnoy "Barbarians as the gatekeepers? A proposal for a modified strict liability regime" 2001 (*Wash ULQ*) 491 501; Richter *Die Verwendung von Ratings zur Regulierung des Kapitalmarkts* (2008) 72.

[7] Partnoy "The Siskel and Ebert of financial markets? Two thumbs down for the credit agencies" 1999 *Wash ULQ* 619 629; Schwarcz "Private ordering of public markets: the rating agency paradox" 2002 *U Illinois LR* 1 14; Kuhner "Financial rating agencies: are they credible?" 2001 *Schmalenbach Business Review* 1 2. Whether ratings were mostly reliable in the past is disputed. For an empirical study see Husisian "What standard of care should govern the world's shortest editorials? An analysis of bond trading agency liability" 1990 *Cornell LR* 411; Bottini "An examination of the current status of rating agencies and proposals for limited oversight of such agencies" 1993 *San Diego LR* 579 583; Partnoy (n 6) 509.

[8] Zentraler "Kreditausschuss Stellungnahme zur Tätigkeit von Rating-Agenturen und ihrer möglichen Regulierung" (14 Aug 2003) 5 http://www.zka-online.de/uploads/media/030815_ZKA-Stn_Rating-Agenturen.pdf (6-01-2009). New agencies are thus left with market niches, see *eg* Strunz-Happe "Externe Ratingagenturen – Marktregulierung durch Basel II, Vorgaben zur Anerkennung als ECAI und die aufsichtsrechtliche Behandlung von externen Ratings" 2004 *WM* 115 120.

To ensure smooth sales of the structured financial products good ratings were essential. Many investors are bound to strict investment rules to avoid concentration risk. Most of the structured financial products received the highest ratings, even though many of their tranches were ultimately collateralised by subprime loans.[9] The credit rating agencies' ratings are paid for by the investment banks selling the financial products and not the investors who buy them.[10] Total revenues for the three largest credit rating agencies doubled from $3 billion in 2002 to over $6 billion in 2007,[11] in part because they increasingly assisted in the development of such structured financial products.[12] As these grew more and more complex it became increasingly difficult for investors to fully understand a product and many investors heavily relied on the AAA/Aaa ratings.[13]

But things got even worse: the credit rating agencies were hesitant to react to the developing crisis, which further aggravated the situation.[14] Although an increasing number of subprime loans defaulted, credit rating agencies stuck to their original high ratings. As time passed, it became more and more obvious that the methods and models applied by the agencies did not adequately reflect the default risk of subprime mortgage loans. These methodical mistakes led to lasting doubts about the reliability of ratings of structured finance products. Only as public pressure grew did credit rating agencies perform a U-turn and extensively downgrade mortgage-backed securities, some radically. Some residential mortgage-backed securities tranches were even downgraded from the highest AAA/Aaa rating to below investment grade in one step.[15] Fitch for example downgraded its rating of GMAC Financial Services by five notches to CCC in November 2008.[16]

[9] See below at 3.1.c.

[10] Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) "Jahresbericht 2007" (2008) 15 ff.

[11] Cyrus Sanati "Rating agencies draw fire on Capitol Hill" *The New York Times* (22 Oct 2008) http://dealbook.blogs.nytimes.com/2008/10/22/rating-agencies-draw-fire-capitol-hill/?scp=1&sq=Cyrus%20Sanati,%20%E2%80%98Rating%20Agencies%20Draw%20Fire%20on%20Capitol%20Hill%E2%80%99&st=cse (5-05-2009), citing Committee on Oversight and Government Reform "Opening statement of rep Henry A Waxman, credit rating agencies and the Financial Crisis" (22 Oct 2008) http://oversight.house.gov/documents/20081022102221.pdf (6-01-2009).

[12] On rating assessment services see Blaurock "Verantwortlichkeit von Ratingagenturen" 2007 *ZGR* 603 607 and 649; Committee of European Securities Regulators "Committee of European Securities Regulators' Report to the European Commission on the Compliance of Credit Agencies with the International Organisation of Securities Commissioners-Code" (Dec 2006, Committee of European Securities Regulators/06-545) 76 www.cesr.eu/popup2.php?id=4093 (6-01-2009); Committee of European Securities Regulators "Committee of European Securities Regulators' Second Report to the European Commission on the Compliance of Credit Rating Agencies with the International Organisation of Securities Commissioners Code and the Role of Credit Rating Agencies in Structured Finance" (May 2008, Committee of European Securities Regulators/08-277) 22 § 102 www.cesr.eu/popup2.php?id=5049 (6-01-2009).

[13] Institute of International Finance (Institute for International Finance) "Interim Report of the Institute for International Finance Committee on Market Best Practices" (April 2008) § 86; Committee of European Securities Regulators "Committee of European Securities Regulators' Second Report to the European Commission on the Compliance of Credit Rating Agencies with the International Organisation of Securities Commissioners Code and the Role of Credit Rating Agencies in Structured Finance" (May 2008, Committee of European Securities Regulators/08-277) 23 § 104 www.cesr.eu/popup2.php?id=5049 (6-01-2009).

[14] Slow downgrading had been heavily criticised as far back as the Enron crisis; see *eg* Hill "Rating agencies behave badly: the case on Enron" 2003 *Conn LR* 1145.

[15] Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) "Jahresbericht 2007" (2008) 18 ff.

[16] Berschens and Cünnen "EU reguliert Bonitätsprüfer" *Handelsbatt* (13-11-2008) 27.

Because residential mortgage-backed securities and collateralised debt obligations were traded globally they are now stuck in numerous banks' balance sheets. Even the German *Landesbanken* – a special type of state-run banks – are seriously affected,[17] some to the extent that mergers have been necessary. Bankruptcies could thus far only be avoided through extensive assistance with public money.[18] Recent months in particular have shown that entire economic sectors are brought into crisis when banks are unwilling or unable to exercise their role as financial intermediaries, and stop granting loans to companies and consumers at adequate terms.[19] The stated efficiency of global capital markets is now turning into its opposite.

1.3 Free flow of information, and avoiding conflicts of interest and supervision are the core regulatory instruments for capital markets

The current crisis demonstrates the importance of functioning capital markets, and why they are of such particular legislative importance.[20] The three core instruments of maintaining functional capital markets are firstly avoiding conflicts of interests, secondly implementing duties to disclose, and thirdly adequate supervision. Managers and banks owe a fiduciary duty to their principals, that is, their shareholders and clients, respectively. They are obliged to exercise the highest standard of care and always act in the best interest of the principals – even and especially where this conflicts with their own interest. The resulting principal-agent problem is well known in corporate governance. Hence, conflicts of interest must be reduced.[21] The economic background of the duty to disclose is the assumption of capital market efficiency. This assumption entails that readily available information is displayed in the market price immediately after it becomes known to the public. The duty to disclose on the one hand ensures that the appropriate information reaches the market and is factored into the price.[22] Insider trading laws, on the other hand, aim to

[17] This was surprising to many people since in the past the *Landesbanken* had a very conservative business model, giving credits to local business only.

[18] For a more detailed report on the impact of the financial crisis on the German *Landesbanken* see Mußler "Das faule System Landesbanken" *Frankfurter Allgemeine Zeitung* (25-02-2009) 13.

[19] Roubini "The current US recession and the risk of a systemic financial crisis" (written testimony for the House of Representatives' Financial Services Committee hearing on 26-02-2008) http://financialservices.house.gov/hearing110/roubini022608.pdf (5-05-2009).

[20] Begründung des Regierungsentwurfs – 12/6679 (27-01-1994) 48; Finanzausschuss "Beschlussempfehlung und Bericht zu dem Gesetzentwurf der Bundesregierung – 12/6679 – 2.FFG" 12/7918 (15-061994) 96; see also Baums "Haftung wegen Falschinformation des Sekundärmarktes" 2003 *ZHR* 139; Fuchs and Dühn "Deliktische Schadensersatzhaftung für falsche Ad-hoc-Mitteilungen" 2002 *BKR* 1063 1069; Möllers in Möllers and Rotter *Ad-hoc-Publizität* (2003) §3 (43); Hopt and Voigt in Hopt and Voigt *Prospekt- und Kapitalmarktinformationshaftung* (2006) 9, 107 and 113; Veil "Die Ad-hoc-Publizitätshaftung im System kapitalmarktrechtlicher Informationshaftung" 2003 *ZHR* 365 367; Zimmer in Schwark (ed) *Kapitalmarktrechtskommentar* (2004) §15 (8) *et seq.*

[21] Akerlof "The market for 'lemons': quality uncertainty and the market mechanism" 1970 *QJE* 488 493; Spence "Job market signaling" 1973 *QJE* 355 374; Bahar and Thévenoz "Conflicts of interest: disclosure, incentives, and the market" in Thévenoz and Bahar (eds) *Conflicts of Interest: Corporate Governance and Financial Markets* (2007) 1; Morkötter and Westerfeld "Asset securitisation: Die Geschäftsmodelle von Ratingagenturen im Spannungsfeld einer Principal-Agent-Betrachtung" 2008 *Zeitschrift für das gesamte Kreditwesen* 393 ff; Hopt *Der Kapitalanlegerschutz im Recht der Banken* (1975) 108 ff; Benicke (n 1) 159.

[22] On information efficiency in the capital market and the efficient capital market hypothesis (ECMH) see for instance Fama "Efficient capital markets: a review of theory and empirical work" 1970 *JF* 83; Fama "Efficient capital markets II" 1991 *JF* 1575; Fischel "Efficient capital markets, the crash, and the fraud on the market theory" 1989 *Cornell LR* 907; Brealey and Myers *Principles of Corporate Finance* (2003) 347; Elton *Modern Portfolio Theory and Investment Analysis* (2003) 402.

frustrate the creation of unreasonable market prices as a result of insufficient information. Behavioural finance research has shown that the "homo economicus", who processes information with strict rationality, is but a theoretical ideal, rarely found in reality. Stock exchanges hence overreact in waves as they display the actions of market participants with so-called bounded rationality,[23] who are also emotionally driven.[24] Maintaining a stable and functioning capital market is, after all, of such high importance that repressive civil law remedies, in other words damage claims, do not suffice as safeguards: preventive public law regulation and supervision has to be implemented as well.[25]

With regard to rating agencies insufficient implementation of all three of these instruments combined to form a perfect storm: first, credit rating agencies are to date *not independent* as they usually rate those companies that hire them (so-called solicited rating).[26] This is aggravated by the fact that, prior to the actual rating, the same agency will often advise the company on how to "compose" a structured finance product in order to receive a certain rating. Secondly, most of the *information* that credit rating agencies used was not reliable. The great majority of subprime products were given the highest ratings, thereby clearly underestimating the major risks inherent in these instruments. Furthermore, when market conditions worsened, the agencies failed to adapt the ratings promptly.[27] Thirdly, a regulatory framework for credit rating agencies which is adequately *supervised* by public law authorities does not currently exist.

1.4 From standards to regulation: The new legal proposals in the United States and the European Union

Until recently, the notion of legal regulation of the credit rating business was largely rejected for a number of reasons. Principally, the market was said to be self-regulating, as credit rating agencies depend heavily on their reputation, and it was assumed that consumers (investors and issuers) would not accept unreliable or dubious conduct.[28] Regarding the implementation of an approval procedure for credit rating agencies, it

[23] Simon "A behavioral model of rational choice" 1958 *QJE con* 99; Choi and Pritchars "Behavioral economics and the Securities Exchange Commission" 2003 *Stanford LR* 1; see also Fleischer *Informationsaymmetrie im Vertragsrecht* (2001) 119.

[24] for instance "lemmings" blindly following the recommendations of alleged financial gurus. On behavioural finance generally see *eg* Shleifer *Inefficient Markets: An Introduction to Behavioral Finance* (2000); Thaler (ed) I *Advances in Behavioral Finances* (1993); Thaler (ed) II *Advances in Behavioral Finances* (2005); Goldberg and von Nitzsch *Behavioral Finance* (2004); Fleischer "Behavioral Law and Economics im Gesellschafts- und Kapitalmarktrecht – ein Werkstattbericht" in Fuchs *et al* (eds) *Wirtschafts- und Privatrecht im Spannungsfeld von Privatautonomie, Wettbewerb und Regulierung – Festschrift für Ulrich Immenga zum 70. Geburtstag* (2004) 575.

[25] Jackson and Roe "Public enforcement of securities laws: resource-based evidence" (2009) Harvard Public Law Working Paper no 08-28 http://ssrn.com/abstract=1000086 (12-05-2009); Köndgen "Regulation of banking services in the European Union" in Basedow and others (eds) *Economic Regulation and Competition of Services in the EU, Germany and Japan* (2002) 27 and 29.

[26] Rating agencies generate 85% of their turnover through solicited rating: see Richter *Die Verwendung von Ratings zur Regulierung des Kapitalmarktes* (2008) 72. Regarding the distinction between solicited and unsolicited rating, see Blaurock "Verantwortlichkeit von Ratingagenturen" 2007 *ZGR* 603 604.

[27] Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008) 2.

[28] As for the dispute see *eg* Partnoy (n 7) 627; Schwarcz (n 7) 1; Fleischer "Gutachten F: Empfiehlt es sich, im Interesse des Anlegerschutzes und zur Förderung des Finanzplatzes Deutschland das Kapitalmarkt- und Börsenrecht neu zu regeln?" in Ständige Deputation des Deutschen Juristentages (ed) *Verhandlungen des 64. Deutscher Juristentag* (2002) F 134.

was argued that this would "wall off" the market; state regulation would also make states jointly responsible for published ratings, which was said to be incompatible with the private sector organisation of credit rating agencies. Investors might also feel tempted to simply rely on the ratings instead of diligently consulting other sources of information. Finally, sovereignty and hence the application of national law is limited to the given state's territory, whereas credit rating agencies operate globally and across borders. The European Union had so far decided against the regulation of ratings.[29]

In American law, a recognition procedure for credit rating agencies has existed since 1975. The underlying legal framework was most recently amended in 2006 with the credit rating agency Duopoly Relief Act.[30] Time had shown that the mere threat of a loss of reputation was – due to the oligopolistic structure of the rating market – not sufficient to achieve high quality standards. Banks and enterprises did not have enough power to enforce higher standards on the credit rating agencies.[31] The main intention behind the legislation was to break the duopoly of Standard & Poor's and Moody's and create transparent rules according to which credit rating agencies are recognised and their ratings are published. Agencies can voluntarily undergo a recognition procedure and attain the status of "Nationally Recognized Statistical Rating Organizations".

Some developments, however, flag a change in the European position. In recent years, Europe and the United States have commenced a "regulatory dialogue" to explore the probable effects of the proposed rules from the outset of the law-making process.[32] The International Organisation of Securities Commissioners has in the past developed new standards for rating agencies.[33] Meanwhile, it is commonly agreed that credit rating agencies contributed significantly to recent market turmoil by underestimating the credit risk of structured credit products.[34] In May 2008, the International Organisation of Securities Commissioners updated its Code of Conduct.[35] In accordance with two statements of the Committee of European Securi-

[29] See Commission (EC) "Communication from the Commission on Credit Rating Agencies" (11 March 2006) OJ 2006/C 59/02, 6: "Its conclusion is that at present no new legislative initiatives are needed".

[30] Credit Rating Agency Reform Act (2006) s 4 inserted as s 15E in Securities Exchange Act (1934) 15 USC §78 *et seq.* See also Partnoy (n 7) 619; Deipenbrock "Der US-amerikanische Rechtsrahmen für das Ratingwesen – ein Modell für die europäische Regulierungsdebatte" 2007 *WM* 2217.

[31] Blaurock "Verantwortlichkeit von Ratingagenturen" 2007 *ZGR* 603 641; Deipenbrock "Aktuelle Rechtsfragen zur Regulierung des Ratingswesens" 2005 *WM* 261 263.

[32] See Hellwig "Der Financial Markets Regulatory Dialogue zwischen EU und USA" in Crezelius *et al* (eds) *Festschrift für Volker Röhricht zum 65. Geburtstag* (2005) 181.

[33] International Organisation of Securities Commissioners "International Organisation of Securities Commissioners Statement of Principles regarding the Activities of Credit Rating Agencies" (25 Sept 2003, International Organisation of Securities CommissionersPD151) http://www.iosco.org/library/pubdocs/pdf/International Organisation of Securities CommissionersPD151.pdf (12-05-2009); The Technical Committee of the International Organisation of Securities Commissioners "Code of Conduct Fundamentals for Credit Rating Agencies" (May 2008, International Organisation of Securities CommissionersPD271) http://www.iosco.org/library/pubdocs/pdf/International Organisation of Securities CommissionersPD271.pdf (12-05-2009). See also Deutscher Bundestag "Rating-Agenturen: Integrität, Unabhängigkeit und Transparenz durch einen Verhaltenskodex verbessern" BT-Drucks 15/2815 (30 March 2004). For both see Deipenbrock 261.

[34] Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on Credit Rating Agencies" COM (0217) 704 final (12 Nov 2008) 2.

[35] The Technical Committee (n 33).

ties Regulators,[36] the European Commission gave up its resistance to regulation. Both the Securities Exchange Commission[37] and the European Commission[38] presented legislative proposals. The Securities Exchange Commission already adopted respective amendments in February of 2009; the compliance date is – with one exception – 10 April 2009.[39] The European Commission published a proposal for a new regulation in November 2008.[40]

In the following section, the legislative proposals from the international, United States and European community are compared. As numerous voices call for an internationally harmonised set of rules,[41] an analysis of the differences between the three legal orders and their potential gaps is also of interest. Individual problem areas will be analysed by means of the instruments of the capital market, particularly the reduction of conflicts of interests, implementing duties to disclose and public supervision. This much can already be said: despite some good attempts, some duties have been regulated by both the Securities Exchange Commission and the European Commission half-heartedly and at times even counterproductively.

2 *Conflicts of interest*

2.1 Reducing conflicts of interest

a) Incompatibility of advisory services and rating

A distinction can be drawn between activity-based and structural conflicts of interest. Likewise, the legal consequences of a conflict of interest can constitute a prohibition or a disclosure obligation of the conflict. The conflicts of interest to which credit rating agencies are susceptible are obvious, as the agencies first give advice on a financial product and then rate the same. To the extent that this is so in any given situation, the credit rating agency concerned cannot be considered independent. The International Organisation of Securities Commissioners Code of Conduct requirement is couched in relatively general terms, that a credit rating

[36] Committee of European Securities Regulators "Consultation paper – the role of credit rating agencies in structured finance" (Feb 2008, Committee of European Securities Regulators 08-036) http://www.cesr-eu.org/popup2.php?id=4951; Committee of European Securities Regulators "Committee of European Securities Regulators' Second Report to the European Commission on the Compliance of Credit Rating Agencies with the International Organisation of Securities Commissioners Code and the Role of Credit Rating Agencies in Structured Finance" (May 2008, Committee of European Securities Regulators/08-277) www.cesr.eu/popup2.php?id=5049 (14-05-2009).

[37] Securities Exchange Commission "Proposed rules for nationally recognized statistical rating organizations" (2008) Release No 34-57967, CFR Parts 240 and 249b http://www.sec.gov/rules/proposed/2008/34-57967fr.pdf (14-05-2009).

[38] Commission (EC) "Consultation paper for a proposal for a regulation of the European Parliament and of the Council on Credit Rating Agencies" (Jul 2008) http://ec.europa.eu/internal_market/consultations/ docs/securities_agencies/consultation-cra-framework_en.pdf (14-05-2009).

[39] Securities Exchange Commission "Amendments to Rules for Nationally Recognized Statistical Rating Organizations" (2008) Release No 34-59342 CFR Parts 240 and 249b http://www.sec/rules/proposes/34-59342 (14-05-2009).

[40] Commission (EC) "Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies" COM (0217) 704 final (12 Nov 2008).

[41] See *eg* Committee of European Securities Regulators "Committee of European Securities Regulators' response to the consultation document of the Commission services on a draft proposal for a Directive/Regulation on Credit Rating Agencies" (Sept 2008, Committee of European Securities Regulators/08-671) 2 http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/ financial_services/credit_agencies/authorities/cerslpdf/_EN_1.0_&a=d (14-05-2009). Among the voices are also credit rating agencies such as Fitch. See Berschens and Cünnen "EU reguliert Bonitätsprüfer" *Handelsbatt* (13-11-2008) 27.

agency *should* separate its credit rating business from any other businesses of the credit rating agency, including consulting businesses, which may present a conflict of interest.[42] In contrast, under American law, credit rating agencies are prohibited from making recommendations to the obligor or the issuer.[43] The European Union's proposal for a Regulation puts it more precisely: a credit rating agency shall not provide consultancy or advisory services to the rated entity or any related third party regarding the corporate or legal structure, assets, liabilities or activities of the rated entity or any related third party.[44]

b) Rotation of analysts and revenue barrier

Numerous other restrictions exist that aim to avoid conflicts of interest. For example, in the United States, rating analysts may not accept any gifts that have an aggregate value of more than US $25.[45] Under both European and American law, rating analysts may not provide credit rating services to the same rated entity for a period exceeding four years.[46] Variations exist among the regulations regarding dependence due to revenues. According to the International Organisation of Securities Commissioners Code of Conduct, a credit rating agency should *disclose* if it receives 10% or more of its annual revenue from a single issuer, originator, client or subscriber.[47] This provision was transformed into a prohibition in the United States.[48] By imposing a ban on rating an entity "from which the credit rating agency receives 5% or more of its annual revenue from the issuance of credit ratings",[49] the original consultation paper of the European Commission was even stricter. In the current proposal for a credit rating agency regulation, the prohibition to issue rat-

[42] The Technical Committee of the International Organisation of Securities Commissioners "Code of Conduct Fundamentals for Credit Rating Agencies" (May 2008, International Organisation of Securities CommissionersPD271) 2.5 http://www.iosco.org/library/pubdocs/pdf/International Organisation of Securities CommissionersPD271.pdf (12-05-2009).

[43] 17 CFR §240.17g-5 (c)(5). See Securities Exchange Commission Release No 34-59342, 105.

[44] a 5 and annex IB No 4 of Commission (EC) "Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies" COM (0217) 704 final (12 Nov 2008).

[45] 17 CFR §240.17g-5(c)(7). See also Securities Exchange Commission Release No 34-59342 (2008) 48 *et seq.*

[46] a 6.4 of Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008); The Committee on Economic and Monetary Affairs, is now suggesting five years: see Amendment 32 (a 6.4) of the Commission (EC) "Draft report on the proposal for a regulation of the European Parliament and of the Council on credit rating agencies" (13 Jan 2009, COM (0217) 704), http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML +COMPARL+PE-418.199+01+DOC+PDF+V0//EN&language=EN (14-05-2009). The European Parliament adopted at its first reading a different a 6.4: "A credit rating agency shall establish an appropriate gradual rotation mechanism with regard to the rating analysts and persons approving credit ratings as defined in Section C of Annex I. That rotation mechanism shall be undertaken in phases on the basis of individuals rather than of a complete team." Parliament (EC) "Position of the European Parliament adopted at first hearing on 23 April 2009 with a view to the adoption of Directive *2009/.../EC* of the European Parliament and of the Council on Credit Rating Agencies" (April 2009, P6_TA-PROV(2009)0279) http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2009-0279+0+DOC+XML+V0//EN (19-05-2009).

[47] The Technical Committee of the International Organisation of Securities Commissioners "Code of Conduct Fundamentals for Credit Rating Agencies" (May 2008, International Organisation of Securities CommissionersPD271) http://www.iosco.org/library/pubdocs/pdf/International Organisation of Securities CommissionersPD271.pdf (12-05-2009) 2.08 (b).

[48] 17 CFR § 240.17g-5(c)(1).

[49] a 9.3(a) of Commission (EC) "Consultation paper for a proposal for a regulation of the European Parliament and of the Council on credit rating agencies" (Jul 2008) http://ec.europa.eu/internal_market/consultations/docs/securities_agencies/consultation-cra-framework_en.pdf (14-05-2009).

ings once certain revenue levels were reached was transformed into an obligation to disclose the existing conflict of interest.[50]

2.2 Comments

a) Missing specification

Whether or not advisory services and ratings should be strictly divided was hotly disputed. A separation of advisory services and rating, one could argue, is not possible with the duopoly of Moody's and Standard & Poor's. However, new market segments can be created by a separation of advisory and rating services. For instance, in European law the independence of auditors was unified in 2006 and a prohibition of self-review adopted.[51] German courts had already confirmed the existence of such a rule in the 1990s.[52] In the United States, the Sarbanes-Oxley Act (SOX) of 2 February 2002[53] likewise prohibits self-review. A registered public accounting firm violates this provision whenever it provides a range of listed financial services contemporaneously with its audit of the issuer.[54] Hence the adoption of a prohibition of self-review must be seen as fundamentally positive.

However, the precise meaning of "advisory service" remains unclear, as the American legislation is weak on specifics. The proposal for a regulation demands on the one hand that a credit rating agency ensures its analysts do not make proposals or recommendations, formally or informally, regarding the design of structured finance instruments on which the credit rating agency is expected to issue a credit rating.[55] On the other hand, a credit rating agency may provide services other than issuance of credit ratings, hereinafter "ancillary services". It shall ensure that the provision of ancillary services does not present a conflict of interest with its credit rating activity, but the credit rating agency itself determines what it considers to be ancillary services.[56]

[50] a 5.1 and 2 and Annex IB No 2 of Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008).

[51] a 22 of Council (EC) 2006/43 of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC 2006 OJ L157/87.

[52] BGH Urt vom 21 Apr 1997 – II ZR 317/95, BGHZ 135, 260; OLG Karlsruhe, Urt vom 23 Nov 1995 – 9 U 24/95 1996 *NJW-RR* 603.

[53] Sarbanes-Oxley Act (2002) 116 Stat 745. For pertinent comments see: Schmidt "Neue Anforderungen an die Unabhängigkeit des Abschlussprüfers: Securities Exchange Commission-Verordnung im Vergleich mit den Empfehlungen der EU-Kommission und den Plänen der Bundesregierung" 2003 *BB* 779; Arbeitskreis "Externe und interne Überwachung der Unternehmung" der Schmalenbach Gesellschaft für Betriebswirtschaft eV "Auswirkung des Sarbanes-Oxley Act auf die Interne und Externe Unternehmungsüberwachung" 2004 *BB* 2399.

[54] Sarbanes-Oxley Act (2002) 116 Stat 745 s 201 inserted as s 10A(g) of the Securities Exchange Act (1934) 15 USC 78j-1; Securities Exchange Commission "Final rule: strengthening the commission's requirements regarding auditor independence" (2003) Release No 33-8183, 17 CFR Parts 210, 240, 249 and 274, amendments to s 210.2-01 "Qualifications of accountants" 69 *et seq* http://sec.gov/rules/final/33-8183.htm (14-05-2009). See also Schmidt (n 53) 781.

[55] a 5 and annex IB No 5 of Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008).

[56] a 5 and annex IB No 4 indent 2 of Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008). Specification now in a 5 and annex IB No 4 indent 2 of Parliament (EC) "Position of the European Parliament adopted at first hearing on 23 April 2009 with a view to the adoption of Directive *2009/.../EC* of the European Parliament and of the Council on credit rating agencies" (April 2009, P6_TA-PROV(2009)0279): "Ancillary services are not part of the credit rating activity but comprise market forecasts, estimates of economic trends, pricing analysis and other general data analysis as well as related distribution services." http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2009-0279+0+DOC+XML+V0//EN (19-05-2009).

It is quite obvious that further specification is needed, and the wording of the American SOX Act could certainly be instructive. In this case, an explanation of the reasons why a particular indicative rating was reached would not properly be seen as an undue recommendation to the issuer, contrary to some assertions in the political discussion.[57]

b) Duty of rotation, suspension from duty and market entry barriers

The goal behind implementing a duty of rotation was to prevent close relationships and ties between analysts and rated entities, and the resulting conflicts of interest. In general, such a duty is also recognised by credit rating agencies.[58] However, analysts need to interact with the rated entity in order to gain experience and insight into the specific characteristics of the company involved.[59] It seems contradictory that the proposal for a regulation requires of the credit rating agencies on the one hand appropriate knowledge and experience of their staff, but on the other hand restricts the scope of staff-client experiences.[60] Thus it would seem that the quality of ratings might be impaired more by the tight, one-size-fits-all timeframe used in the proposal than by the risk of potential conflicts of interests arising from a lengthy professional relationship would.[61] Considering this, it might be wiser to prescribe only the change of the "lead analyst" on credit rating agencies.[62]

The original requirement of the European Commission that credit rating agencies would not be permitted to issue a rating on an entity from which they received more than 5% in total annual revenue was heavily criticised in the consultation proce-

[57] This was argued by: German Banking Industry Associations "Comments of the German Banking Industry Associations on the European Commission's consultation papers for a directive/regulation of the European Parliament and of the Council on credit rating agencies and on tackling the problem of excessive reliance on ratings" (5 Sept 2008, Ref. BdB:L2.3 – Kp/To) 6, http://circa.europa.eu/Public/irc/markt/ markt_consultations/library?l=/financial_services/credit_agencies/organisations&vm=detailed&sb=Title (14-05-2009); The Committee on Economic and Monetary Affairs "Draft Report on the proposal for a regulation of the European Parliament and of the Council on credit rating agencies" (13-01-2009, COM (0217) 704), asks for further concretisation of these broad terms in suggestion 26 on a 5(1)(*c*) http://www.europarl. europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-418.199+01+DOC+PDF+V0//EN& language=EN (14-05-2009).

[58] Fitch Ratings "Response to a draft directive/regulation with respect to the authorisation, operation and supervision of credit rating agencies" (5 Sept 2008) 8, http://circa.europa.eu/Public/irc/markt/ markt_consultations/library?l=/financial_services/credit_agencies/citizens/fitchpdf/_EN_1.0_&a=d (14-05-2009); Moody's Investors Service Ltd "Response to a draft directive/regulation with respect to the authorisation, operation and supervision of credit rating agencies" (5 Sept 2008) 21, http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/citizens/moodyspdf/_EN_1.0_&a=d (14-05-2009).

[59] German Banking Industry Associations (n 57).

[60] a 6.1 of Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008).

[61] German Banking Industry Associations (n 57).

[62] GDV German Insurance Association "Comment on the European Commission's consultation documents on credit rating agencies" (5 Sept 2008) 10, http://circa.europa.eu/Public/irc/markt/markt_consultations/ library?l=/financial_services/credit_agencies/organisations/insurance_gdvpdf/_EN_1.0_&a=d (14-05-2009); Moody's Investors Service Ltd "Response to a draft directive/regulation with respect to the authorisation, operation and supervision of credit rating agencies" (5 Sept 2008) 22, http://circa.europa.eu/Public/irc/markt/ markt_consultations/library?l=/financial_ services/credit_agencies/citizens/moodyspdf/_EN_1.0_&a=d (14-05-2009).

dure.[63] In fact, new rating agencies would have to have over 20 clients from day one to avoid running foul of this requirement. If the aim of the legislation is also to break the existing duopoly, then regulations which strengthen the current market structure should be avoided.[64] As a result, the disclosure obligations implemented by the International Organisation of Securities Commissioners and the current proposal are sufficient, and the United States' regulation seems excessive. Investors can decide themselves on the relevance of the conflict of interests.

c) *De lege ferenda*: increasing unsolicited rating

These measures are without doubt helpful in reducing conflicts of interest. However, conflicts of interest can never be completely avoided so long as solicited rating takes place – the saying "he who pays the piper calls the tune" is pertinent here.[65] The regulation thus does not prevent conflicts of interest, but rather reduces them. It would therefore be a positive development were unsolicited ratings to gain in importance. Hitherto, the market for unsolicited ratings has mostly been limited to follow-up ratings. A promising structural change would be for market participants to order and pay for ratings. As competition seems to be increasing, it seems likely that the market is developing in this direction. Egan-Jones Ratings, for example, no longer issues solicited ratings, and advertises a "no-conflicts-of-interest" policy.[66]

However, unsolicited ratings also have disadvantages, and are themselves not without controversy.[67] Despite all duties to disclose, the information available to an agency performing an unsolicited rating is considerably less than in the case of a solicited rating. For this reason, unsolicited ratings may only partially address the informational asymmetry discussed above.[68] Critics also stress that credit rating agencies might use unsolicited ratings to increase their market share. By giving issuers a lower, unsolicited rating, the agencies could try to force unwilling issuers to pay for their services in the hope of getting a better rating.[69] Credit rating agencies may threaten issuers with unduly low ratings in order to obtain more business and fees.[70] The most prominent case illustrating this problem involved Moody's, which assigned an unsolicited rating of bonds that was substantially lower than the rat-

[63] German Banking Industry Associations "Comments of the German Banking Industry Associations on the European Commission's consultation papers for a directive/regulation of the European Parliament and of the Council on credit rating agencies and on tackling the problem of excessive reliance on ratings" (5 Sept 2008, Ref BdB:L2.3 – Kp/To) 5 *et seq*, http://circa.europa.eu/Public/irc/markt/markt_consultations/ library?l=/financial_services/credit_agencies/organisations&vm=detailed&sb=Title (14-05-2009); Fitch Ratings "Response to a draft directive/regulation with respect to the authorisation, operation and supervision of credit rating agencies" (5 Sept 2008) 7, http://circa.europa.eu/Public/irc/markt/markt_ consultations/library?l=/financial_services/credit_agencies/citizens/fitchpdf/_EN_1.0_&a=d (14-05-2009).

[64] See also the Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008) 2.

[65] The German version of the saying goes: "Wes' Brot ich ess', des' Lied ich sing" – whose bread I eat, his song I sing.

[66] http://www.egan-jones.com.

[67] Rousseau "Enhancing the accountability of credit rating agencies: the case for a disclosure-based approach" 2006 *McGill LJ* 617 637.

[68] Habersack "Rechtsfragen des Emittenten-Ratings" 2005 *ZHR* 185.

[69] Pinto "Control and responsibility of credit rating agencies in the United States" 2006 *Am J Comp L* 341 344.

[70] Partnoy "How and why credit rating agencies are not like other gatekeepers" in Fuchita and Litan (eds) *Financial Gatekeepers – Can they protect investors?* (2006) 71.

ings issued by other agencies.[71] In addition, unsolicited ratings allegedly distort the pricing mechanism, because they tend to be less accurate, given the more limited amount of information on which they rely.[72] However, aside from the Moody's incident there is little evidence to support the claim that unsolicited ratings are substantially lower than solicited ratings.[73]

These views are paramount in clarifying the true contribution of unsolicited ratings. Still, in the absence of convincing empirical evidence, they cannot be taken to mean that unsolicited ratings actually do have a positive impact on the market. Given the Moody's case, there continues to be a risk that this practice may lead to its own form of abuse.[74] Another option is for securities supervision authorities to request the creation of ratings from the credit rating agencies similar to audits of financial services companies by chartered accountants. The German Supervisory Authority for Financial Services (*Bundesanstalt für Finanzdienstleistunsaufsicht* – hereinafter *BaFin*), instructs chartered accountants to verify whether a financial services company has complied with its duties to inform and advise its clients (see §§35 and 36 *Wertpapierhandelsgesetz* or *Securities Trading Act* – hereinafter *WpHG*). In order to allow the credit rating agency to base its rating on reliable information, they should be vested with the authority to request information from the company and gain entry to its premises. The costs for this rating would have to be borne by the company being rated. This approach would close the informational gap between the solicited and the unsolicited rating while at the same time ensuring the independence of the credit rating agencies.

3 *Duties to disclose*

3.1 The essential element of any rating: likelihood of default

a) The proposals of the International Organisation of Securities Commissioners, the Securities Exchange Commission and the European Commission

The revised International Organisation of Securities Commissioners Code of Conduct for credit rating agencies provides fundamentals that already address issues in connection with the rating of structured finance products. It states that credit rating agencies are to "avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading". The credit rating agencies should state clearly when a product "involves missing or limited historical data".[75] In addition,

[71] *Jefferson County School District No R-1 v Moody's Investor's Services, Inc* 175 F 3d 848 (10th Cir 1999). See also Pinto "Control and responsibility of credit rating agencies in the United States" 2006 *Am J Comp L* 341 354; Partnoy (n 70) 71.

[72] Schwarcz (n 7) 16.

[73] Schwarcz (n 7) 16.

[74] Rousseau "Enhancing the accountability of credit rating agencies: the case for a disclosure-based approach" 2006 *McGill LJ* 617 637.

[75] The Technical Committee of the International Organisation of Securities Commissioners "Code of Conduct Fundamentals for Credit Rating Agencies" (May 2008, International Organisation of Securities CommissionersPD271) 1.6, 1.7 and 1.7-3, http://www.iosco.org/library/pubdocs/pdf/International Organisation of Securities CommissionersPD271.pdf (12-05-2009).

"a CRA *should differentiate ratings of structured finance products* from traditional corporate bond ratings, *preferably through a different rating symbol.* A CRA should disclose how this differentiation functions. A CRA should clearly define a given rating symbol and apply it in a consistent manner for all types of securities to which the symbol is assigned."[76]

The first United States proposal from June 2008 incorporated these rules and also suggested a new rule that would require Nationally Recognised Statistical Rating Organisationss to distinguish their ratings for structured finance products from other classes of credit ratings by publishing a report with the rating or using a different rating symbol. It was suggested that such rating symbols could be created by appending identifying characters to existing rating scales, for example "AAA.sf" or "AAASF."[77] However, the final act that was passed in February of 2009 does not contain any such rules. Neither was a distinction between the different finance products introduced, nor a separate risk class created.[78]

The European Commission's proposal for a regulation requires credit rating agencies to disclose to the public the methodologies, models and key rating assumptions they use in the rating process; all information that is used in assigning a credit rating is to be of sufficient quality and from reliable sources.[79] Moreover, credit rating agencies are required to disclose if they have relied on a third-party assessment for a rating.[80] With regard to the distinction of structured finance products ratings, the Commission's Consultation Paper states that "a credit rating agency shall ensure that rating categories that may be attributed to structured finance instruments are clearly differentiated from rating categories that may be used to rate other finance instruments".[81] However, the current proposal for a credit rating agency regulation deviates from this approach and leaves credit rating agencies the choice between introducing different credit rating categories and simply warning of the particular risks of structured finance instruments in a separate report.[82] Thus, both the Euro-

[76] The Technical Committee of the International Organisation of Securities Commissioners "Code of Conduct Fundamentals for Credit Rating Agencies" (May 2008, International Organisation of Securities CommissionersPD271) (3.5(b)) http://www.iosco.org/library/pubdocs/pdf/International Organisation of Securities CommissionersPD271.pdf (12-05-2009).

[77] Securities Exchange Commission "Proposed rules for nationally recognized statistical rating organizations" (2008) Release No 34-57967, 17 CFR Parts 229, 230, 239, and 240, 98.

[78] Securities Exchange Commission "Amendments to rules for nationally recognized statistical rating organizations" (2009) Release No 34-59342, 17 CFR Parts 240 and 249b, http://www.sec.gov/rules/final/2009/34-59342.pdf (14-05-2009).

[79] a 7 of Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008).

[80] a 8.2 and annex ID II No 2 of Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008).

[81] a 14.3 of Commission (EC) "Consultation paper for a proposal for a regulation of the European Parliament and of the Council on credit rating agencies", July 2008 http://ec.europa.eu/internal_market/consultations/ docs/securities_agencies/consultation-cra-framework_en.pdf (14-05-2009).

[82] a 8.3 of Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008) reads: "When a credit rating agency issues a rating for structured finance instruments it shall ensure either of the following:

a) credit rating categories that may be attributed to structured finance instruments are clearly differentiated from rating categories that may be used to rate other types of rated entities or financial instruments;

b) publish a report that provides a detailed description of the rating methodology used to determine the credit rating and an explanation of how it differs from the determination of ratings for any other type of rated entity or financial instrument, and how the credit risk characteristics associated with a structured finance instrument differ from the risks related to any other type of rated entity or financial instrument."

pean proposal for a credit rating agency regulation and American law fall short of their underlying proposals.[83]

b) A U-turn and successful lobbying

The International Organisation of Securities Commissioners,[84] the Securities Exchange Commission[85] and the European Commission[86] were not the only ones to demand a different rating symbol for structured finance products in July 2008. Other competent institutions such as the Financial Stability Forum,[87] the Committee of European Securities Regulators,[88] the Institute for International Finance[89] and the German *Sachverständigenrat* (Council of Economic Experts)[90] were making the same demands. Hence, it is very surprising that only a few months later the Securities Exchange Commission and the European Commission backed down. Was this due to successful lobbying by the credit rating agencies? Two of the three major agencies protested against the introduction of a different rating symbol for structured finance products. What were their arguments? Fitch Ratings made the case that it would be more logical in theory and useful for market participants in practice for structured finance ratings to be accompanied by one or more complementary ratings and indicators – for example, default/loss severity or collateral quality assessment.[91] Moody's statement reads dramatically:

[83] Whereas the European parliament requires a distinguishing symbol for structured finance instruments, see a 8.3 of Parliament (EC) "Position of the European Parliament adopted at first hearing on 23 April 2009 with a view to the adoption of Directive *2009/.../EC* of the European Parliament and of the council on credit rating agencies" (April 2009, P6_TA-PROV(2009)0279): "When a credit rating agency issues credit ratings for structured finance instruments it shall ensure that rating categories that are attributed to structured finance instruments are clearly differentiated using an additional symbol which distinguishes them from rating categories used for any other entities, financial instruments or financial obligations." http://www.europarl. europa.eu/sides/getDoc.do?pubRef=-// EP//TEXT+TA+P6-TA-2009-0279+0+DOC+XML+V0//EN (19-05-2009).

[84] See Schwarcz (n 7) 16.

[85] Securities Exchange Commission "Proposed rules for nationally recognized statistical rating organizations" (2008) Release No 34-57967, 97.

[86] Commission (EC) "Reasons to the consultation paper for a proposal for a regulation of the European Parliament and of the Council on credit rating agencies" Jul 2008 § 14 http://ec.europa.eu/internal_ market /consultations/docs/securities_agencies/consultation-cra-framework_en.pdf (14-05-2009).

[87] Financial Stability Forum (Financial Stability Forum) "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience" (7 Apr 2008) 34 www.fsforum.org/ publications/r_0804.pdf (12-05-2009).

[88] Committee of European Securities Regulators "Committee of European Securities Regulators's Second Report to the European Commission on the compliance of credit rating agencies with the International Organisation of Securities Commissioners code and the role of credit rating agencies in structured finance" (May 2008, Committee of European Securities Regulators/08-277) 26.122, www.cesr.eu/popup2.php?id= 5049 (14-05-2009).

[89] Institute of International Finance (Institute for International Finance) "Interim Report of the Institute for International Finance Committee on Market Best Practices" (Apr 2008) § 88.c, www.iasplus. com/crunch/ 0804iifbestpractices.pdf (12-05-2009).

[90] The "German Council of Economic Experts" Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung "Das Erreichte nicht verspielen" (Jahresgutachten 2007/08, 7 Nov 2007) 248, http://www.sachverstaendigenrat-wirtschaft.de/gutacht/ga-content.php?gaid=52 (14-05-2009); Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung "Die Finanzkrise meistern – Wachstumskräfte stärken" (Jahresgutachten 2008/09, 12 Nov 2008) 229, http://www. sachverstaendigenrat-wirtschaft.de/gutacht/ga-content.php?gaid=53%20&node=a (19-05-2009).

[91] Fitch Ratings "Response to a draft directive/regulation with respect to the authorisation, operation and supervision of credit rating agencies" (5 Sept 2008) 9,http://circa.europa.eu/Public/irc/markt/ markt_ consultations/library?l=/financial_services/credit_agencies/citizens/fitchpdf/_EN_1.0_&a=d (14-05-2009).

> "A prescriptive and detailed legislation could create a false sense of security among market participants that credit ratings published in such a heavily regulated environment are government approved and therefore will be viewed as assurance, rather than an opinion about an entity's creditworthiness. Ironically, and contrary to the Commission's broader stated policy agenda of 'decreasing reliance' on credit rating agencies, a more detailed regulatory regime could solidify a perception that market participants need not undertake their own analysis in making investment decisions and can instead rely upon ratings with impunity. We believe that establishing such a perception in the financial markets is dangerous and must be avoided."[92]

According to a study conducted by Moody's, the majority of the sampled investors oppose a change of the rating categories currently employed. Simply adding new rating symbols would neither provide additional information nor urge investors to undertake their own risk assessment.[93] Were an additional rating category to be introduced, one of the key benefits of ratings – enabling a meaningful comparison between the relative probability of default between different securities with different structures and origins – would be lost.[94] Such a process would further create unnecessary costs in the market and hence be disproportionate.[95] Standard & Poor's, R & I and other credit rating agencies approved the wording of the current proposal for a credit rating agency regulation.[96]

c) The complexity of structured finance instruments – toxic papers

One cannot argue the counter case without taking a closer look at structured finance products. We have seen that investment banks purchased loans, pooled and structured them and then sold the majority of tranches with a good or even excellent rating, although these consisted to a significant degree of subprime loans.[97]

[92] Moody's Investors Service Ltd (n 91).

[93] Moody's Investors Service Ltd (n 92) 23: "We received over 200 submissions from institutions representing more than $9 trillion in fixed income assets under management. About three quarters of all respondents (both by number and assets under management) strongly advised no change to the rating scale currently used by MIS for rating structured securities. Many respondents also expressed the view that using the same rating scale but adding a modifier to all structured finance ratings would be merely a cosmetic change" http://circa.europa.eu/Public/irc/markt/markt_consultations/ library?l=/financial_services/ credit_agencies/citizens/moodyspdf/_EN_1.0_&a=d (14-05-2009).

[94] Comments of the German Banking Industry Associations "Comments of the German Banking Industry Associations on the European Commission's consultation papers for a directive/regulation of the European Parliament and of the Council on credit rating agencies and on tackling the problem of excessive reliance on ratings" (5 Sept 2008, Ref BdB:L2.3 – Kp/To) 8.

[95] HM Treasury, FSA and Bank of England "Joint response on a draft Directive/Regulation on the authorisation, operation and supervision of credit rating agencies" (5 Sept 2008) 20, http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/authorities/uk_ministry.pdf/_EN_1.0_&a=d (19-05-2009).

[96] R&I "Comments on European Commission Draft" (5 Sept 2008) 15; Sharma "Remarks by S&P President Deven Sharma at Committee of European Securities Regulators conference" (23 Feb 2009), http://www2.standardandpoors.com/spf/pdf/media/DS_Committee of European Securities Regulators_ remarks_feb09%20_2.pdf?vregion=au&vlang=en (19-05-2009). Statements by the Investment Company Institute also advocate such a legal differentiation in the US (25 Jul 2008) 3 http://www.ici.org/statements/ cmltr/08_sec_cra_com.html#TopOfPage (21-05-2009).

[97] See above § 1.2.

Collateralised debt obligations differ from ordinary finance products like government bonds or corporate bonds in at least five ways: Firstly, structured finance products were so novel as to have virtually no track-record on which to gauge their likelihood of default. [98] Secondly, the little history that did exist occurred under very advantageous economic conditions: high economic growth, interest rates at historic lows, very low volatility in interest rates and a period where housing prices increased consistently year after year.[99] Thirdly, losses on a portfolio were not prorated to the individual tranche, but always assigned to the lowest tranche (first-loss tranche or equity tranche). Were the losses to exceed that tranche's value, the next tranche up would have to absorb the losses – from there the pattern continues (so-called waterfall structure). In this way the more senior tranches were – at least for a period of time – protected against losses. Credit rating agencies therefore frequently rated these tranches, which usually made up 60–70 % of a portfolio, with the highest possible credit rating, "AAA".[100] Fourthly, the lower-rated "BBB" tranches of different portfolios were often pooled again and turned into a new portfolio. Risks were reduced by diversification, for example by including "BBB" tranches from other areas such as credit card loans or car loans. This newly created portfolio was then tranched once again, thus creating new "valuable" "AAA" and "AA" tranches.[101] Fifthly, as a study conducted by Standard & Poor's demonstrates, even a relatively small change of the fundamental investment conditions can cause a significant loss in value. While the "AA+" tranche, for example, has a calculated net present value of 75.76% under scenario four, it depreciates to a mere 8.85% in scenario five.[102] This explains the radical, sudden downgrades of four or five notches.[103] It is also the reason why investors are reluctant to purchase collateralised debt obligations. Due to the unresolved question of appropriate valuation that is caused by the unclear default risks, all plans for governments to buy these structured finance products from banks have failed.

[98] Bundesanstalt für Finanzdienstleistungsaufsicht "Jahresbericht 2007" (2008) 15; The de Larosière Group "Report of the High-Level Group on Financial Supervision in the EU" (25 Feb 2009) 20, http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf (19-05-2009).

[99] Securities Exchange Commission "Summary Report of issues identified in the commission staff's examinations of select credit rating agencies" (Jul 2008) 35 http://www.sec.gov/news/studies/2008/craexamination070808.pdf (19-05-2009).

[100] Krahnen "Der Handel von Kreditrisiko: eine neue Dimension des Kapitalmarktes" 2005 *Perspektiven der Wirtschaftspolitik* 499; The "German Council of Economic Experts" Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung "Das Erreichte nicht verspielen" (Jahresgutachten 2007/08, 7 Nov 2007) § 155, http://www.sachverstaendigenrat-wirtschaft.de/gutacht/ga-content.php?gaid=52 (14-05-2009); see also Rudolph and Scholz "Driving factors of the subprime crises and some reform proposals" CESifo DICE Report 3/2008, 14, http://www.cesifo-group.de/pls/guestci/download/CESifo%20DICE%20 Report%202008/CESifo%20DICE%20Report%203/2008%20/dicereport308-forum3.pdf (19-05-2009); Fehr "Strukturierte Anleihen sind derzeit kaum zu bewerten" *Frankfurter Allgemeine Zeitung* (25-02-2009) 20.

[101] The instrument is known as a collateralised debt obligations-squared, see http://www.investopedia.com/ terms/c/cdo2.asp.

[102] Standard & Poor's "Valuing structured finance assets 101: what are these things really worth?" (3 Nov 2008) Market Intellect from Standard & Poor's, www2.standardandpoors.com/spf/pdf/fixedincome/Valuing%20SF%20Assets%20101.pdf.

[103] See n 16.

3.2 Legal implications

a) The necessity of a differentiation between ordinary and structured finance products

The president of the *Deutsche Bundesbank* (German Central Bank), Axel Weber, called it "financial alchemy", the possibility of transforming "*vin de pays* into a *cru* by changing the label".[104] In politics, structured finance products are nowadays called "toxic papers"[105] and should be transferred to a "bad bank". Without a doubt, collateralised debt obligations carry a significantly higher risk and are "more dangerous" than ordinary finance products. With regard to national economics, however, it might be useful to keep permitting international trade with mortgage-backed securities and similar instruments, because they allow banks to diversify and thus reduce their risks and enable investors, for example insurance companies, to achieve high returns.[106] Credit rating agencies were very successful for many years and continue to benefit from their good reputation. However, the positive ratings of complex products, which today are worth virtually nothing, have significantly contributed to the financial crisis. Rating such products only makes sense insofar as the rating does not significantly under- or overestimate the associated risks. In the long run, only ratings correctly gauging the risk associated with a financial instrument can contribute to the creation of trust in the market.[107]

The particular risks associated with these products should be disclosed to investors. Moody's statement – that this would keep investors from diligently undertaking their own risk assessment[108] – is both right and wrong. Right, because credit rating agencies only issue opinions: they cannot make the decision for the investor. Ultimately, the investor has to make his or her own investment decision. Wrong, and even cynical, because advising of the particular risks of a product is one of the main purposes of credit rating agencies. The new American law could well be judged insufficient in this respect. It does not require structured finance products to be designated as such nor for a separate report to be published.[109] It also falls short of the International Organisation of Securities Commissioners Code of Conduct.

[104] Weber "Financial market stability" (speech at the London School of Economics, 6 Jun 2008) 2f, www.bis.org/review/r080610a.pdf (19-05-2009) referring to "German Council of Economic Experts" (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung) "Das Erreichte nicht verspielen" (Jahresgutachten 2007/08, 7 Nov 2007) http://www.sachverstaendigenrat-wirtschaft.de/gutacht/ga-content.php?gaid=52 (14-05-2009). For the German version see: "Die Subprime-Krise. Ursachen und Folgen für das Kreditwesen" (Rede anlässlich des FTD Bankengipfels), www.bundesbank.de/download/presse/reden/2008/20080425.weber.php (19-05-2009).

[105] Weber (n 104).

[106] The "German Council of Economic Experts" Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung "Das Erreichte nicht verspielen" (Jahresgutachten 2007/08, 7 Nov 2007) § 164, http://www.sachverstaendigenrat-wirtschaft.de/gutacht/ga-content.php?gaid=52 (14-05-2009); also adressed by Weber "Financial market stability" (speech at the London School of Economics 6 Jun 2008) 2f, www.bis.org/review/r080610a.pdf (19-05-2009).

[107] See above at § 1.2.

[108] Moody's Investors Service Ltd (n 92) 7, http://circa.europa.eu/Public/irc/markt/ markt_consultations/library?l=/financial_services/credit_agencies/citizens/moodyspdf/_EN_1.0_&a=d (14-05-2009).

[109] Gilani "Fraud and greed of trusted rating agencies helped spread the credit crisis" (18-12-2008), http://www.moneymorning.com/2008/12/18/debt-rating-agencies/ (19-05-2009).

b) Further specification and differentiated classification (AAAsF)

The European proposal for a regulation adopts the propositions of the International Organisation of Securities Commissioners Code of Conduct. It requires credit rating agencies to *disclose missing historical data*[110] and recommends that they *refrain from issuing a rating* in cases where serious questions exist as to the credit rating agency's ability to determine a credible credit rating for the security.[111] This can be further concretised: a concrete risk is the risk of a heavy downgrading of such financial products by *multiple ranks*. According to a survey of the Bank of England, the probability of structured finance products being downgraded by more than one notch was twice as high as that of corporate bonds with the same creditworthiness.[112]

If the aim is to highlight the differences between ordinary and structured finance products, then it would seem necessary to adjust the Proposal for a Regulation. The measures needed to maintain the appropriate level of flexibility would be, according to the Lamfalussy Process, provided in an Implementing Regulation.[113] Were such a report to be rejected, the high risks of structured finance products would force credit rating agencies to rate these products lower from the very beginning.

The rating, as a solicited rating, is initially only available to the client and not to the public. Therefore a high risk exists that the report would not be acknowledged adequately by the public and would therefore be misleading, as the recent past has demonstrated.[114] Hence, many factors argue in favour of creating a separate rating category for structured finance products, for example AAAsF. Again, the goal is not, as was suggested, to create a false sense of security, but to point out the "peculiarities" of these finance products by means of a differentiated classification. A distinction seems all the more appropriate in light of the fact that special rating symbols are already used in other areas.[115]

[110] The Technical Committee of the International Organisation of Securities Commissioners "Code of Conduct Fundamentals for Credit Rating Agencies" (May 2008, International Organisation of Securities CommissionersPD271) § 1.7 http://www.iosco.org/library/pubdocs/pdf/International Organisation of Securities CommissionersPD271.pdf (12-05-2009); a 8.2 and annex IID I No 3 of Commission (EC) "Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies" COM (0217) 704 final (12 Nov 2008).

[111] The Technical Committee § 1.7-3 http://www.iosco.org/library/pubdocs/pdf/International Organisation of Securities CommissionersPD271.pdf (12-05-2009); a 8.2 and annex IID I No 3 of Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008).

[112] Bank of England "Financial Stability Report" Issue 22 (25 Oct 2007) 57; The "German Council of Economic Experts" (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung) "Das Erreichte nicht verspielen" (Jahresgutachten 2007/08, 7 Nov 2007) (248) http://www.sachverstaendigenrat-wirtschaft.de/gutacht/ga-content.php?gaid=52 (14-05-2009).

[113] Arguing against a too detailed regulation in the first stage of the Lamfalussy Process: Committee of European Securities Regulators "Committee of European Securities Regulators's response to the consultation document of the Commission services on a draft proposal for a Directive/Regulation on Credit Rating Agencies" (Sept 2008, Committee of European Securities Regulators/08-671) II.2 http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies/authorities/cerslpdf/_EN_1.0_&a=d (14-05-2009). For general information concerning the Lamfalussy Process: Möllers "Europäische Methoden- und Gesetzgebungslehre im Kapitalmarktrecht – Vollharmonisierung, Generalklauseln und soft law im Rahmen des Lamfalussy-Verfahrens als Mittel zur Etablierung von Standards" 2008 *ZEuP* 480.

[114] Commission (EC) "Consultation paper for a proposal for a regulation of the European Parliament and of the Council on credit rating agencies" Jul 2008, http://ec.europa.eu/internal_market/consultations/docs/securities_agencies/consultation-cra-framework_en.pdf (14-05-2009).

[115] *eg* ratings such as "pi" or short-term ratings such as Moody's "P-1". See Richter *Die Verwendung von Ratings zur Regulierung des Kapitalmarkts* (2008) 60.

Such obligations to inform and duties to warn would have three desired consequences. Firstly, in appropriate cases, rating agencies would avoid reviewing the structured products, to avoid a possible breach. The European proposal for a credit rating agency regulation is couched in the following terms: "In cases where the lack of reliable data or the complexity of the structure of a new type of 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."[116] Secondly, the fulfilment of such duties could be monitored by supervisory authorities, presumably leading to a higher rate of compliance. Thirdly, the imposition of such duties might also result in a potential *ex post* liability for breaches through private litigation.[117]

Therefore, the responsible committees should return to their original position that ratings of ordinary finance products and ratings of structured finance products be differentiated. The Larosière Report[118] fortunately made similar demands; the statement of the Committee on Economic and Monetary Affairs, in contrast, remains unclear.[119]

4 *Regulating the rating agencies*

4.1 The current state of regulation

The International Organisation of Securities Commissioners relies on voluntary compliance and asks only that rating agencies disclose whether they comply with the International Organisation of Securities Commissioners Code of Conduct and, if they do not, explain where and why they deviate.[120] In the United States, on the

[116] a 8.2 and annex ID I No3 indent 2 of Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008).

[117] See Ebenroth and Dillon "The international rating game: an analysis of the liability of rating agencies in Europe, England and the United States" 1993 *Law & Policy Intl Bus* 703; Pinto "Control and responsibility of credit rating agencies in the United States" 2006 *AJ Comparative L* 341 351; Partnoy (n 6) 491; Habersack "Rechtsfragen des Emittenten-Ratings" 2005 *ZHR* 185 199; Blaurock "Verantwortlichkeit von Ratingagenturen" 2007 *ZGR* 603 627. On the question of *Haftungsprivilegierung* of rating agencies under the Securities Exchange Act, see Langevoort "Information technology and the structure of securities regulation" 1985 *Harvard LR* 747 776.

[118] The de Larosière Group "Report of the High-Level Group on Financial Supervision in the EU" (25 Feb 2009) 71, recommendation 3: "Finally, the rating of structured products should be transformed with a new, distinct code alerting investors about the complexity of the instrument", http://ec.europa.eu/commission_ barroso/president/pdf/statement_20090225_en.pdf (19-05-2009).

[119] The Committee on Economic and Monetary Affairs "Draft report on the proposal for a regulation of the European Parliament and of the Council on credit rating agencies" (13 Jan 2009, COM (0217) 704), Amendment 18: "Therefore credit rating agencies should use different rating categories when rating structured finance instruments and provide additional information on the different risk characteristics of these products. They should also indicate when rating a product for the first time and when rating a newly-created product." http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-418.199+01+DOC+PDF+V0//EN&language=EN (14-05-2009). However, this change is not reflected in a 8.3 of Commission (EC) "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies" COM (0217) 704 final (12 Nov 2008).

[120] The Technical Committee (n 110) 4.1: "A CRA should disclose to the public its code of conduct and describe how the provisions of its code of conduct fully implement the provisions of the International Organisation of Securities Commissioners Code and Principles. If a CRA's code of conduct deviates from the International Organisation of Securities Commissioners provisions, the CRA should explain where and why these deviations exist ... ." http://www.iosco.org/library/pubdocs/pdf/International Organisation of Securities CommissionersPD271.pdf (12-05-2009).

other hand, a rating agency has to register with the Securities Exchange Commission in order to become a nationally recognised statistical rating organisation. The status of a nationally recognised statistical rating organisation is important, because another government regulation stipulates that certain institutions are only to rely on the ratings issued by nationally recognised statistical rating organisations. Home loan banks, for example, have to determine the applicable credit risk percentage using ratings by nationally recognised statistical rating organisations.[121] Furthermore, several investment funds and similar entities have internal policies that require that nationally recognised statistical rating organisations are consulted on ratings.[122] So far, ten rating agencies have met all the conditions for registration set forth in section 15E(a)(1)(B) of the Securities Exchange Act and have attained the status of a nationally recognised statistical rating organisation.[123] Despite the common notion that regulatory requirements often act as barriers to entry,[124] in this instance, they helped smaller rating agencies overcome their lack of reputation in the market. Meeting the government's standards for registration was substituted by a proven track record.[125] The EU Commission views the oligopolistic market structure as the main cause for the lack of qualitative competition observed in the market for credit ratings.[126] The EU Commission therefore proposes to create EU regulation setting up a registration and surveillance framework for credit rating agencies.[127] This would level the playing field between the United States and Europe, which is especially important since credit rating agencies operate globally.[128] Those who push for a European registration requirement also hope that, as in the United States, registration will help smaller credit rating agencies to compete with the international titans.

4.2 Differences between the United States and the European Union – the missing European supervisory authority

In Europe, the question of who should be responsible for the registration and supervision of credit rating agencies has been intensely debated. According to the EU Commission's proposal of November 2008, that question should be assigned to the financial supervision authorities of the individual member states. To ensure uniform registration procedures and requirements, the applications should first be assessed by the Committee of European Securities Regulators.[129] The national financial supervision authorities should also consult the Committee of European Securities Regulators on questions relating to the supervision of credit rating agencies.[130] The

[121] See the US Federal Home Loan Bank Capital Requirements in 12 CFR 932.4, available at http://edocket.access.gpo.gov/cfr_2003/12CFR932.4.htm (21-05-2009).

[122] *eg* Gladstone Capital Corp, http://www.gladstonecapital.com/ (21-05-2009).

[123] These are: Moody's Investor Service, Standard & Poor's, Fitch Ratings, AM Best Company, Dominion Bond Rating Service, Ltd, Japan Credit Rating Agency, Ltd, R&I, Inc, Egan-Jones Ratings Company, LACE Financial, Realpoint LLC.

[124] An example of regulation acting as a barrier to entry in the health care sector is given in Haas-Wilson *Managed Care and Monopoly Power: The Antitrust Challenge* (2003) 131.

[125] Everling and Trieu "Ratingagenturen weltweit" in Büschgen and Everling (eds) *Handbuch Rating* (2007) 95 and 114.

[126] Commission (EC) "Proposal for a regulation of the European Parliament and of the council on credit rating agencies" COM (0217) 704 final (12 Nov 2008) 2.

[127] Commission (n 126) 5 ff.

[128] Commission (n 126) 3.

[129] a 13 of Commission (EC) (n 126).

[130] a 21.2 of Commission (n 126).

power to sanction a credit rating agency, however – for example by publication of violations (so-called "name and shame") or by imposing a suspension of the use of credit ratings with effect throughout the Community – is reserved for the competent authority of the home member state of the credit rating agency.[131] The European Central Bank,[132] the Committee on Economic and Monetary Affairs of the European Parliament[133] and the Larosière Report[134] deem this approach too complicated and propose instead to confer authority on the Committee of European Securities Regulators to handle the registration and supervision, including the power to levy sanctions. This question relates to the ongoing debate on European centralism and the principle of subsidiarity (a 5.2 TEC). Those who prefer the member states to retain the competence to regulate the credit rating agencies stress the benefits of regulatory competition,[135] while others warn of a "race to the bottom". Currently, the Committee of European Securities Regulators' organisational structure and lack of regulatory authority prevent it from becoming the European equivalent to the United States Securities Exchange Commission. First of all, unlike the Securities Exchange Commission, which has various powers under the Securities Exchange Act to promulgate rules related to the issuing and trading of securities, the Committee of European Securities Regulators can merely issue recommendations, which have only a very indirect legal effect.[136] Furthermore, according to article 1.1 of the Committee of European Securities Regulators' Charter,[137] each member state designates a representative from the competent authorities in the securities field to participate in the meetings of the committee. This leads to the Committee of European Securities Regulators being a rather large decision-making body, consisting of representatives who all push their national agendas. The Committee of European Securities Regulators' statement on the EU Commission's proposal is emblematic of how difficult it is for the committee to agree on a single position: some preferred self-regulation, others a stronger cooperative approach, a third group agreed with the EU Commission's proposal and another view favoured the creation of a European Securities Agency. The last proposal – forming a European Financial Services

[131] a 21.2 of Commission (n 126). The home member state is the state in which the credit rating agency has its registered office, see Commission (nn 126) 9.

[132] Kafsack and Paul "Ein Frühwarnsystem für die Finanzmärkte" *Frankfurter Allgemeine Zeitung* (26-02-2009) 11.

[133] The Committee on Economic and Monetary Affairs "Draft Report on the proposal for a regulation of the European Parliament and of the Council on Credit Rating Agencies" (13 Jan 2009, COM (0217) 704) 47f, (Amendment 69) http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+ PE-418.199+01+DOC+PDF+V0//EN&language=EN (14-05-2009).

[134] The de Larosière Group "Report of the High-Level Group on Financial Supervision in the EU" (25 Feb 2009) (67, Recommendation 3), http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf (19-05-2009).

[135] Jackson and Pan "Regulatory competition in international securities markets: evidence from Europe in 1999-Part I" 2001 *Bus Law* 653; Jackson and Pan "Regulatory competition in international securities markets: evidence from Europe – Part II" 3 *VA Law & Business R* 207; Köndgen "Regulation of banking services in the European Union" in Basedow *et al* (eds) *Economic Regulation and Competition of Services in the EU, Germany and Japan* (2002) 27 and 29.

[136] Möllers "European legal theory and legislation in capital market law, complete harmonization, blanket clauses and soft law as means for creating standards in the context of the Lamfalussy Process" 2009 *JIE* 20; Möllers "Sekundäre Rechtsquellen. Eine Skizze zur Vermutungswirkung und zum Vertrauensschutz bei Urteilen, Verwaltungsvorschriften und privater Normsetzung" in Möllers and Kort (eds) *Festschrift für Herbert Buchner* (2009) 649.

[137] Committee of European Securities Regulators, Charter of the Committee of European Securities Regulators (Sept 2008, Committee of European Securities Regulators/08-375d), http://www.cesr-eu.org/popup2.php?id=5192.

Supervision Authority – is highly controversial.[138] Because of the high costs associated with complying with 27 different regulatory regimes, large banks have repeatedly called for such a "lead supervisor." The German government still opposes this idea, however.[139] If capital market law is to be taken seriously, regulation has to be backed by effective enforcement. Currently, weak enforcement mechanisms are the Achilles' heel of the European capital market law. European antitrust law is vigorously enforced and companies around the globe who form cartels affecting the European internal market have to fear the draconian sanctions imposed by the European Union Commission.[140] This powerful enforcement of European law is just as important in the area of securities regulation. Therefore, a central supervisory authority with powers similar to those of the Directorate General for Competition of the European Commission seems the way to go.

5 *Summary and outlook*

There can be no doubt about the need to regulate credit rating agencies on an international level. Rules about avoiding conflicts of interests, duties to make information publicly available and a procedure for registration are important cornerstones for an international regulatory framework.

It is a good sign that, in the United States and the European Union alike, regulators seem to have realised that relying on the voluntary compliance of credit rating agencies with non-binding codes of conduct is not enough. The current avalanche of regulation proposals reflects the need for swift action.

i There remains some room for improvement, though: the rules about separating credit rating and consulting have to be rendered more precisely. They could be modelled on the restrictions on providing auditing and consultancy services to the same client, which apply to licensed credit rating agencies.

ii Using different rating symbols for structured finance products would provide investors with important, easy-to-grasp information about the class of products they are investing in. The current implementation of the pertinent International Organisation of Securities Commissioners proposals leaves much to be desired: in the United States the proposals were not implemented at all and in Europe the implementation is half-hearted at best.

iii It is doubtful whether all 27 member states have the resources to set up efficient registration procedures and supervise credit rating agencies. The Committee of European Securities Regulators lacks the legal authority to do so. Despite these shortcomings of the *status quo*, only a minority of the member states supports the creation of a dedicated European Securities Authority. This lack of effective and uniform enforcement is the Achilles' heel of European securities regulation.

[138] Merkt "Gutachten G: Empfiehlt es sich, im Interesse des Anlegerschutzes und zur Förderung des Finanzplatzes Deutschland das Kapitalmarkt- und Börsenrecht neu zu regeln?" in Standing Committee of the German Law Congress (ed) *Verhandlungen des 64. Deutscher Juristentag* (2002) G124; Binder and Broichhausen "Entwicklungslinien und Perspektiven des Europäischen Kapitalmarktrechts" 2006 *ZBB* 97; Cruickshank "Cooperation and convergence" in Oditah (ed) *The Future for the Global Security Market: Legal and Regulatory Aspects* (1996) 267.

[139] *Frankfurter Allgemeine Zeitung* (7-07-2006) 12.

[140] Recently the car glass cartel received a record fine of €1.4 billion. See Kores "Car glass cartel" (Opening Remarks at Press Conference, Brussels 12 Nov 2008), http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/604&type=HTML.

iv According to the recent *Larosière Report*, the creation of a European Securities Authority is not a viable option because of insufficient political support. It therefore proposes to furnish the Committee of European Securities Regulators with the legal powers to issue binding standards. This would be a step in the right direction.

v All parties concerned have repeatedly stressed the importance of a global and uniform solution. The work done by the International Organisation of Securities Commissioners has created a solid basis for a further harmonisation of securities laws. However, as argued in this article, there are still some major issues that are approached differently in the United States and Europe.

It now seems possible to answer the question of the subtitle: reducing conflicts of interest, stipulating reporting requirements and duties to inform as well as effective public supervision of credit rating agencies are important steps – important *first* steps, however. They have to be buttressed by defining more precisely the possible conflicts of interest and the necessary measures to avoid them as well as an effective framework for monitoring credit rating agencies. These issues so far have not been addressed with the necessary determination. One moral of Shakespeare's 1599 comedy *Much Ado About Nothing* is that "all that glitters is not gold". The higher risk associated with structured finance products must be reflected in the ratings in order to ensure proper information in the capital markets. Without these steps, investors might again be misled by the glitter only to find out that they have bought the twenty-first century equivalent of fool's gold.

SAMEVATTING

REGULERING VAN KREDIETGRADERINGSINSTANSIES – NUWE AMERIKAANSE EN EUROPESE STATUTÊRE INGREPE – BELANGRIKE VERSTELLINGS OF 'N GROOT BOHAAI OOR NIKS?

In hierdie artikel bespreek die outeur verskillende oorsake van die huidige finansiële krisis en in die besonder die gestruktureerde finansiële produkte (die sogenaamde besmette papiere) wat weens hul uitstaande graderings deur meerdere banke en ander finansiële instellings wêreldwyd vir beleggingsdoeleindes aangekoop is. Intussen word markdeelnemers nie langer toegelaat om self hul eie maatstawwe en standaarde te stel nie en word die toepaslike mark veel strenger as vantevore gereguleer. Die onlangse regulerende voorskrifte van toepassing op die sogenaamde graderingsinstansies bied 'n voorbeeld van hoe die Amerikaanse en die Europese wetgewers poog om meer effektiewe beheer oor die aspek van dié finansiële mark uit te oefen. Die outeur kom tot die gevolgtrekking dat die voorlopige resultate uiteenlopend is en geen eenvormige suksesverhaal is nie.