Dealing with the conflicts of interest of credit rating agencies: a balanced cure for the disease

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Key points

- The credit rating industry has long been plagued by acute conflicts of interest, which has led to a paramount level of rating inflation and the catastrophic failure of credit rating agencies (CRAs) in their roles as financial informational intermediaries during the Financial Crisis 2007–2008.
- The 'issuer-pay' business model is the root cause of this problem, although this remuneration model was classed as one of the most significant innovations of the credit rating industry for enhancing the industry's sustainability and competitiveness in modern times.
- EU law is more effective and multifaceted with a focus on dealing with the 'disease' with a balanced cure while avoiding the overhaul of the 'issuer-pay' business model. The shareholding limitation rules, the mandatory contract rotation rule and the double rating rule should be feasible solutions in reducing conflicts of interest as well as improving competition, industry diversity and the rating quality of CRAs.
- The US legal reforms are partially successful, although gaps still exist because the SEC failed to improve the 'issuer-pay' model and other existing provisions are relatively weak. The ineffectiveness of the US law has a detrimental effect on the international rating industry because the most influential CRAs are subject to US law.
- This article proposes that the US regulators should press on with more regulatory effort to adopt the Franken Amendment/Random Selection Model with further refinements. Since the SEC showed little intention to adopt this model, the EU multifaceted model, together with several additional improvements, can provide a more effective solution.

1. Introduction

The leading international credit rating agencies (CRAs), namely Moody's, S&P and Fitch (the 'Big Three'), and other CRAs adopted the 'issuer-pay' model in the late 1960s and early 1970s[1] and started to charge issuers for ratings to fund their services. The adoption of the 'issuer-pay' business model enabled CRAs to overcome the problem of the 'freeriding' public goods problem and to assess additional non-public information. The freeriding problem, which sprung from the 'investor-pay' model, a dominant remuneration model adopted by CRAs before 1970, was a major problem causing a loss of profit and incentives for the rating industry. This problem can be more severe for CRAs, which are one of the

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1 Timothy J Sinclair, 'Credit rating agencies'. In D Coen, GK Wilson and W Grant, Wyn, (eds) *The Oxford Handbook of Business and Government* (OUP 2010) 424.

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dominant informational intermediaries in the financial market. A credit rating is a 'public good'. Once it is published and disseminated to the public, it can be leaked to others who have not paid for the information.[2] The value of ratings can suffer from depreciation when there is a freeriding problem, such as ratings being photocopied[3] under the 'investor-pay' model. It can cause information leakage as investors can use information contained in prices to free ride.[4] It can lead to the collapse of the information market where no other investors want to buy the information,[5] resulting in a loss of revenue for the rating producer, who had undergone a lengthy process of information gathering and assessing. This change of business model constituted a key innovation for the credit rating industry[6] and was crucial for the sustainability of the entire rating industry.

Nonetheless, while the 'issuer-pay' business model brought much prosperity to the industry in modern times, the 'issuer-pay' model was the root cause of conflicts of interest, mainly due to the remuneration method and the cosy commercial relationship between issuers and CRAs under this business model. The Financial Crisis of 2007–2008 (the Crisis) signified some organizational problems which existed in the current dominant 'issuer-pay' business model, such as conflicts of interest, which constituted a major defect of CRAs as well as leading to their catastrophic failure in their roles as financial intermediaries and financial gatekeepers. This was evident in the highly inflated credit ratings of structured financial products (SFPs) and their paramount downgrades during the Crisis. CRAs face this problem more severely than any other financial gatekeepers for reasons such as the 'issuer-pay' remuneration model and the selling of ancillary services to clients.[7]

The US and EU regulators adopted a series of law reforms to address the conflicts of interest and the rating inflation issues of CRAs following the call for more rigorous regulation on CRAs after the Crisis. Both legal systems took a similar approach to enhance the independence and integrity of CRAs, although some of these provisions, such as the internal control policies and procedures, relied heavily on the CRAs' self-compliance, resulting in these provisions being less effective in dealing with the conflicts of interest. The US Congress attempted to deal with the problem at its root cause by requiring the SEC to establish a system for assigning a Nationally Recognised Statistical Rating Organisation (NRSRO) to determine the initial credit ratings of SFPs.[8] The SEC adopted the term of NRSRO for a qualified CRA in 1975 to ensure only ratings assigned by NRSROs were used for regulatory purposes, such as to set the minimum regulatory capital requirements for

2 John Coffee, 'The Ratings Agencies', *Gatekeepers: The Professions and Corporate Governance* (OUP 2006) 295.

3 Lawrence White, 'The Credit Rating Agencies' (Spring 2010) 24 (2) Journal of Economic Perspectives 211–26, 3.

4 Vasiliki Skreta and Laura Veldkamp, 'Rating Shopping and Asset Complexity: A Theory for Ratings Inflation' (2009) Working Paper 14761, 1.

5 Ibid 21.

6 Richard Sylla, 'An Historical Primer on the Business of Credit Rating', *Ratings, Rating Agencies and The Global Financial System* (Kluwer Academic Publisher 2002) 35.

7 Marco Pagano and Paolo Volpin, 'Credit Rating Failures and Policy Options' (2010) 25 (62) Economic Policy 401–31, 412; Frank Partnoy, 'How and Why Credit Rating Agencies are not like other Gatekeepers' (2006) University of San Diego, Legal Studies Research Paper Series, No 07-46, 60.

8 15 USC 78o–9(b) & (d).

broker-dealers.[9] The 'Big Three' were the first three CRAs to receive the NRSRO status. The US Congress's intended system should prevent issuers or subscribers from choosing NRSROs and placing pressure on the chosen NRSRO for more favourable ratings. Nonetheless, the SEC's inaction to commence this system, with the best contender being the Franken Amendment/Random Selection Model,[10] meant that little had been achieved under the US law reforms.

In contrast, the EU's approach is multifaceted and provides a more balanced cure to deal with the 'disease' without having to make a drastic change to the 'issuer-pay' business model. The EU's approach, such as the mandatory contract rotation rule and the double-rating rule, provides a valuable example for other regulators, although regulators should consider widening the application of the mandatory contract rotation rule to cover all other SFPs. In contrast, this article criticizes the USA's inability to deal with conflicts of interest of CRAs is consequential to the fact that the biggest three CRAs, which issued 95.1 per cent of global outstanding bond ratings in 2019,[11] are all US companies; hence, they are subject to US regulation. Without having a firm grip on the conflicts of interest problem, the international CRAs are prone to rating inflation, which results in impeding the CRAs' key roles of informational intermediaries and financial gatekeepers.

This article provides a critical analysis of the conflicts of interest of CRAs, the links with the CRAs' business model and the different regulatory reforms in the USA and the EU to eliminate the conflicts of interest and the rating inflation issue. It proposes that the US regulators should seek to either follow the EU model or to adopt the modified Franken Amendment/Random Selection Model to effectively address the conflicts of interest and the rating inflation issue. While the SEC showed little intention to adopt the latter, the EU's multifaceted approach with further improvement provides a robust solution for the conflicts of interest problem as well as dealing with other issues, such as improving competition, industrial diversity and the rating quality of CRAs. Section 2 evaluates the transition of the business model from 'investor-pay' to 'issuer-pay' with a focus on the major contributions of the latter to the rating industry. Section 3 analyses the causes of conflicts of interest and the connection with credit rating inflation. Sections 4 and 5 provide a comprehensive evaluation of the USA and EU's regulatory reforms in dealing with the conflicts of interest problem. In conclusion, Section 6 proposes a further improvement of the laws.

2. Transition from 'investor-pay' model to 'issuer-pay' business model

Before the 'issuer-pay' model, the international CRAs has mainly adopted the 'investor-pay' business model since 1909, by which CRAs sold ratings to investors or others who

9 7 CFR s 240.15c3-1, Rule 15c3-1.

10 GAO (a), 'Credit Rating Agencies, Alterative Compensation Models for Nationally Recognised Statistical Rating Organisations' (2012) GAO-12-240, 1.

11 SEC, Office of Credit Ratings, 'Annual Report on Nationally Recognised Statistical Rating Organisations, As required by Section 6 of the Credit Rating Agency Reform Act of 2006' (December 2020), 10.

were willing to pay the rating information. It should be that noted only a small number of CRAs are still thriving under the 'investor-pay' model, including KMV, Egan-Jones and Lace Financial.[12] The current most used business model is the 'issuer-pay' model. Ninety per cent of the rating industry's revenues are from issuer's fees,[13] while 99 per cent of the outstanding NRSRO credit ratings were issued under the 'issuer-pay' model in 2011.[14] The transition of the business model from 'investor-pay' to 'issuer-pay' constituted one of the key developments of the rating industry for solving the freeriding problem. It ensured economic viability as well as competitiveness for this industry.

First, the 'issuer-pay' model resolved the freeriding problem. The 'issuer-pay' model benefits the investment market because all market participants can access the rating information at the same time.[15] For this reason the issuers would still be willing to pay for ratings because issuers can maximize the prices of the credit products when investors are better informed. The industry is much in favour of the 'issuer-pay' model, holding that the issuers should pay for the substantial value of ratings for market access.[16] From the economic point of view, the issuer would be willing to pay for the ratings if the ultimate profit can cover the cost for ratings. Putting this into perspective, the rating fees would be approximately one billion dollars for the gain of multi-trillion dollars of issues rated in aggregate.[17]

The 'investor-pay' model did not yield sufficient returns to justify intensive coverage and failed to meet the demand for increasingly faster and more comprehensive service.[18] The industry took the view that the publication subscriptions alone were not sufficient to compensate their staff within the increasing scope and complexity of the capital markets at higher levels.[19] The 'issuer-pay' model solves this problem as it allows the CRAs to tax all users of ratings via the issuers, who would pass this expenditure to individual bonds securities. Therefore, the 'issuer-pay' model contributed to the large growth of the rating industry, which was a key element for the continued prosperity of the CRAs. It has produced a very profitable rating industry since the 1970s, eg, a margin reached 49 per cent in 2017 in Moody's case.[20]

Secondly, the 'investor-pay' model deprived CRAs of information advantage compared to the 'issuer-pay' model, under which the CRAs had a special privilege accessing non-public information from the issuers, which are the information holders. Before 1970 credit ratings did not outperform the other measures under the 'investor-pay' model because all

12 White (n 3) 218.

13 Partnoy (n 7) 62.

14 GAO (n 10) 7.

15 Miller Mathis et al, 'The Role of the Credit Rating Agencies Structured Finance Market, Hearing before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, US House of Representatives' (2007) One Hundred Tenth Congress, First Session, 27 September, 2007, Serial No 110-62 (thereafter 'The Role of the Credit Rating Agencies'), 161.

16 Moody's, 'A Century of Market Leadership', 2018 <https://www.moodys.com/Pages/atc001.aspx> accessed 25 August 2021.

17 Frank Partnoy, 'The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies' (1999) 7 (3) Washington University Law Review 619–714, 654.

18 Richard Cantor and Frank Packer, 'The Credit Rating Industry' (1994) FRBNY Quarterly Review/Summer–Fall 4.

19 Moody's (n 16).

20 Bloomberg, Moody's Company Filing in 2017.

their analyses were based on the same public information.[21] Inevitably, the efficiency of CRAs depends on their ability to obtain more valuable information, thus outperforming competitors. The 'issuer-pay' model satisfies this requirement as CRAs have direct access to more detailed information submitted by the rated entities about the financial products. The confidential clause that CRAs are exempted from Regulation FD also granted CRAs the right of non-disclosure of confidential information,[22] ie, CRAs have the right to receive non-public confidential information from issuers without being subject to public disclosure.[23] This exemption has since been removed according to the SEC's final rules in 2010.[24] This exemption made it possible for CRAs to carry out the role of an informational intermediary for credit assessment, whilst protecting confidential information from being disseminated to the public. The functions of reducing cost and disseminating information to the world without disclosing confidential information was a key feature as well as an advantage of CRAs.[25] As the financial market matures and the information market becomes more efficient the 'issuer-pay' model should continually assist CRAs to gain non-publicly disclosed information. In general, the adoption of the 'issuer-pay' model was driven by the need for improving the economic viability and sustainability of the rating industry. This change was a major innovation, which increased the competitiveness and profitability of the industry.

3. Causes of conflicts of interest and rating inflation

Causes

First, conflicts of interest mainly derive from the remuneration method, ie, CRAs are paid by issuers under the 'issuer-pay' model, by which issuers can exert pressure on CRAs for higher ratings by changing CRAs. The issuers' autonomy over the contractual relationship with CRAs can lead to rating shopping and rating inflation because CRAs are under pressure to produce more lax ratings to retain business from issuers.[26] The cause of conflicts of interest is that investors are the principles of the rating service, for which the CRAs' work is done,[27] contrary to the fact that issuers contract and pay for CRAs. *United States v Arthur Young & Co*[28] held that a public gatekeeper (an auditor) should always maintain total independence from the client and require complete fidelity to the public trust.[29]

21 W Braddock Hickman, 'Introduction and Summary', *Corporate Bond Quality and Investor Experience* (Princeton University Press 1958) 12; Sylla (n 6) 26.

22 SEC, 'Final Rule: Selective Disclosure and Insider Trading' (2000) 17 CFR Parts 240, 243, and 249 <https://www.sec.gov/rules/final/33-7881.htm> accessed 5 September 2021, S II(B)(1)(a); 17 CFR 243.100(b)(2)(iii), Exempting from Regulation FD: 'an entity whose primary business is the issuance of credit ratings, provided the information is disclosed for the purpose of developing a credit rating and the entity's ratings are publicly available'.

23 'The Role of the Credit Rating Agencies' (n 15) 134; Coffee (n 2) 288.

24 SEC, 'Removal from Regulation FD of the Exemption for Credit Rating Agencies' (2010) 17 CFR Part 243, <https://www.sec.gov/rules/final/2010/33-9146.pdf> accessed on 5 September 2021, S(I).

25 Coffee (n 2) 287.

26 'The Role of the Credit Rating Agencies' (n 15) 13.

27 Sinclair (n 1) 431.

28 *United States v Arthur Young & Co* (1984) 465 US 805, 818–19.

29 Ibid 817–18.

CRAs should also remain independent from the corporations or entities who pay for services and be accountable to the public, although this independence has not always been achieved in practice.

Secondly, the reputation cost was insufficient to incentivize CRAs to eliminate conflicts of interest. The reputation mechanism is the main incentive for CRAs to maintain their quality of service so that CRAs can increase the market shares over time.[30] Between the 1970s and the 2000s, commentators believed the major CRAs struck a good balance between avoiding conflicts of interest and preserving the CRA's reputation by separating salary and revenue streams through internal operating procedures and analysts' compensation policies.[31] This reputational cost could in reality no longer provide sufficient incentives for CRAs to eliminate conflicts of interest in recent years. The quality of ratings progressively declined when the MBS market peaked between the start of 2005 and mid-2007.[32] CRAs are more likely to inflate the quality of investment when investors are more trusting and/or when the CRAs' expected reputation costs are lower, particularly during economic boom times.[33] The conflicts of interest problem was more severe when the economy was booming with a low reputational cost for CRAs and more trusting investors. The SEC staff working paper discovered that an employee of an unnamed CRA appeared to have engaged in personal trading practices inconsistent with this firm's policies.[34] The fact that analysts had direct or indirect personal interests in SFPs may also affect the CRAs' long-term reputation as they may rate the relevant products in accordance with their personal interest.[35] The conduct of the main CRAs in leading up to the Crisis, eg, supporting the rapid growth of the subprime securities market in pursuit of short-term financial gains by applying lax rating methodologies, highlighted the conflicts of interest problem and affected financial gatekeepers' integrity.

Thirdly, long-established policies and practices failed to minimize conflicts of interest. CRAs often defended their position by insisting that they had policies under the self-regulatory initiative, such as requiring rating decisions to be made by a rating committee, imposing investment restrictions, adhering to fixed fee schedules and separating the ratings services from the influence of other businesses.[36] Early in 2003 the SEC's working paper concluded the issuer influence did not lead to significant conflicts of interest.[37]

30 Gianluca Mattarocci, 'Rating Agencies and the Rating Service', *The Independence of Credit Rating Agencies* (Elsevier 2014), ch 1.2; Sinclair (n 1) 424.

31 Roy C Smith and Ingo Walter, 'Rating Agencies: Is There an Agency Issue?' (2001) Insead Working Paper 2001/29/EPS, 43–4; White (n 3) 215.

32 Boom Adam Ashcraft, Paul Goldsmith-Pinkham and James Vickery, 'MBS Ratings and the Mortgage Credit' (2010) Federal Reserve Bank of New York Staff Reports, No 449, 1.

33 Patrick Bolton, Xaiver Freixas and Joel Shapiro, 'The Credit Ratings Game' (2012) 67 Journal of Finance 88, 96.

34 SEC, 'Summary Reports of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies' (2008) <https://www.sec.gov/news/studies/2008/craexamination070808.pdf> accessed 5 September 2021, 23–4, 28.

35 Ibid, 'Two rating agencies do not appear to prohibit structured finance analysts from owning shares of investment banks that may participate in RMBS and CDO transactions'.

36 Amadou NR Sy, 'The Systemic Regulation of Credit Rating Agencies and Rated Markets' (2009) International Monetary Fund, WP/09/129, 9.

37 SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of Securities Markets, as Required by S702(B) of the Sarbanes-Oxley Act Of 2002' (2003) <https://www.sec.gov/news/studies/credratingreport0103.pdf> accessed 5 September 2021, 23.

This conflict was effectively addressed because CRAs implemented a number of policies and procedures to assure the independence and objectivity of the rating process.[38] Nonetheless, conflicts of interest were not always managed appropriately.[39] The SEC's working paper in 2008 identified conflicts of interest in several areas of the CRAs' business operation. For example, some CRAs allowed the key participants in the ratings process to participate in fee discussions contrary to the implemented policies.[40]

Rating inflation

Conflicts of interest can lead to rating shopping and inflation. Accordingly rating inflation was said to have detonated the Crisis.[41] Evidence showed that the number of downgrades of SFPs increased rapidly from 2006 to 2008, which peaked in 2008.[42] The total percentage of the tranches affected by downgrades were 7.2 per cent in 2007 and 6.7 percent in 2008, increasing significantly compared to 1.4 per cent in 2005 and 1.2 per cent in 2006.[43] These figures suggested that credit ratings for structured products were inflated prior to the Crisis, resulting in the loss of credit risk information in the securities market. The AAA rated tranches should have been rated BBB on average, amounting to an additional 12.1 per cent AAA for the average collateralized debt obligations (CDOs).[44] Apart from the close economic tie between issuers and CRAs, the upward biased rating is also caused by more positive and biased information submitted to CRAs and the ancillary service provided by CRAs and the issuers' right to reject the publication of final ratings.

First, CRAs were under financial pressure to apply lax rating methodologies to retain business under the current 'issuer-pay' model, particularly for rating SFPs.[45] The profitability of structured finance was the main cause of the cosy relationship between the raters and issuers.[46] Only a small number of issuers in the structured financial market are in control of a high volume of financial products.[47] Therefore, retaining any one issuer would be crucial for CRAs as the profits are substantial. CRAs would maximize profits by choosing rating inflation and overstating the quality of investment despite the reputation costs.[48] These conflicts of interest could cause dispersive effects on the securities market with the credit risk of securities being underestimated. Moreover, the issuer must supply private information to the raters, leading to more positive and biased information being submitted to the

38 Ibid.

39 SEC, 'Briefing Paper: Roundtable to Examine Oversight of Credit Rating Agencies' (April 2009) <https://www.sec.gov/spotlight/cra-oversight-roundtable/briefing-paper.htm> accessed 24 July 2018.

40 SEC (n 34) 23–4.

41 Pagano and Volpin (n 7) 403–4.

42 Efraim Benmelech and Jennifer Dlugosz, 'The Credit Rating Crisis' (2009) 56 Journal of Monetary Economics 617–34, 178.

43 Ibid 175.

44 John Griffin and Dragon Yongjun Tang, 'Did Subjectivity Play a Role in CDO Credit Ratings?' (2012) LXVII (4) Journal of Finance 1325.

45 Coffee (n 2) 4.

46 'The Role of the Credit Rating Agencies' (n 15) 138.

47 White (n 3) 221.

48 Bolton et al (n 33) 96.

raters.[49] The quality of the rating directly links to the quality of the information provided by issuers, particularly when the law previously did not require CRAs to check the authenticity and accuracy of the information submitted.[50]

Additionally, the solicited rating under the 'issuer-pay' model can generate an upward bias.[51] The raters can advise issuers how to maximize their efficiency and profitability during the interaction stage. Alongside the huge revenue generated from the ratings for SFPs, CRAs also provide ancillary services such as pre-rating assessments, corporate consulting and how to modify risks to achieve high ratings.[52] Ancillary services are a major cause for conflicts of interest under the 'issuer-pay' model because they foster an overly cosy relationship between issuers and CRAs.[53] The inflated ratings were exacerbated by the fact that issuers also have the choice to reject the publication of the final ratings if the publication of such ratings had a negative effect on the entity's performance. The announced rating is the maximum of all realized ratings, resulting in a biased signal of the asset's true quality.[54] The rated entity could have a strong incentive to shop for higher ratings because the upward biased rating can drive the prices of the financial product upwards.

4. US regulation

The Credit Rating Agency Reform Act of 2006

The US regulators enacted two important instruments: the Credit Rating Agency Reform Act of 2006 (the Reform Act) and the Dodd–Frank Wall Street Reform and Consumer Protection Act 2010 (the Dodd–Frank Act) to enhance the oversight and integrity of NRSROs and to address the conflicts of interest issue. The Reform Act increased the integrity of NRSROs in line with the congressional intention[55] by promulgating the SEC to oversee and enforce the provisions under the S 15E Securities Exchange Act 1934, including issuing final rules relating to the prevention of misuse of non-public information, unfair or abusive practices and conflicts of interest.

First, NRSROs must establish and enforce written policies and procedures to prevent the misuse of non-public information by the organization or any person associated with such organizations.[56] Rule 17 g-4 prohibited inappropriate dissemination of non-public information and a person with non-public information from purchasing, selling or otherwise benefiting from any transactions in securities or money market instruments.[57] It aims to

49 Mattarocci (n 30) ch 1.2.3.

50 'The Role of the Credit Rating Agencies' (n 13) 84.

51 Mattarocci (n 30) ch 1.2.3.

52 Marco Pagano, Paolo Volpin and Wolf Wagner, 'Rating Agencies' (April 2010) 25 (62) Economic Policy 401–31, 413.

53 EC, 'Commission Staff Working Document Accompanying the Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies—Impact Assessment' (2008) (com (2008) 704 Final), (SEC(2008) 2746), [3.1.1] and [3.1.2.1]; Amadou (n 36) 4.

54 Skreta and Veldkamp (n 4) 2.

55 Legislative Attorney, 'Credit Rating Agency Reform Act of 2006' (2006) Congressional Research Service, 3.

56 15 USC 78o–7(g).

57 17 CFR s 240.17g-4(a).

correct two types of abusive behaviours with confidential information, ie, the disclosure of confidential information for market manipulation and disruption purposes and the insider trading by the insider exploiting confidential information.[58]

Secondly, the SEC shall issue final rules to prohibit any act or practice that is unfair, coercive or abusive.[59] Previously, CRAs were engaging in abusive practice. For example, some CRAs tried to force their competitors out of certain structured products' ratings by playing 'notching' tricks.[60] These CRAs could 'lower their ratings or refuse to rate on securities issued by certain asset pools unless a substantial portion of assets within those pools were also rated by them'.[61] Less powerful CRAs can be forced out of the market, while issuers have to accept abusive rating behaviours and become tied up with a particular CRA. This section intends to address these abusive conducts by prohibiting activities conditioning the issuance of a rating, threatening to lower a credit rating and modifying a credit rating for the purpose of obtaining other or more services from the issuers.[62]

Thirdly, NRSROs must establish and enforce written policies and procedures to address and manage any conflicts of interest,[63] such as the way that the issuers remunerate NRSROs for their services, the provision of a consulting and advisory service and the business or the financial relationship between NRSROs and issuers.[64] Establishing a written policy and procedure to manage the conflicts of interest rising from the named areas would help to improve the integrity of the NRSROs. Nonetheless, the SEC staff identified several shortcomings during their on-site inspections of NRSROs. Many NRSROs still allowed key analysts to participate in fee discussions in various ways, from discussing fees to influencing rating methodologies.[65] The Reform Act's initiative to implement policies to manage conflicts of interest is a good starting point, although the effect of such implementation could not achieve the Congress's intention fully as NRSROs would nevertheless ignore their own policies.

Rule 17 g-5(b) also lists conflicts of interest which are theoretically prohibited, but in reality 'permitted' as long as NRSROs disclose them and implement policies and procedures to manage them.[66] The permitted conflicts of interest include the conflicts deriving from the remuneration relationship under the 'issuer-pay' model and persons within NRSROs having personal ownership or business relationships in the securities or issuers, which are subjected to the ratings of the same NRSROs.[67] Regarding the 'permitted'

58 Elisabetta Conte and Federico Parmeggiani, 'The Regulation of Credit Rating Agencies across USA and EU: Different Systems, Same Concerns' (2008) University of Siena Law and Economic Working Paper Series, 7.

59 15 USC 78o–7(i)(1).

60 Amadou (n 36) 21.

61 Ibid.

62 Ibid.

63 15 USC 78o–7(h)(1).

64 15 USC 78o–7(h)(2).

65 SEC, 'Summary Report of Issues Identified in the Commission Staff's examination of Select Credit Rating Agencies' (2008) United States Securities and Exchange Commission, July 2008, 23.

66 17 CFR s 240.17g-5(b).

67 Ibid.

conflicts of interest, sections 15E(h)(1) and (2) the Securities Exchange Act 1934 did not go far enough to address the conflicts of interest. They relied heavily on the NRSROs' autonomy to adopt a workable policy for managing conflicts of interest. This self-managing approach coincides with the IOSCO's code of conduct, which had already been adopted by most NRSROs prior to this Act. This Act set out to correct the perceived problems created by the absence of the statutory regulations of CRAs,[68] although, in essence, it merely acted as an acknowledgement of the problem, while failing to add any material impact in eliminating conflicts of interest.

In short, the Reform Act started to reshape the legal framework for the rating industry and to enhance the integrity of NRSROs. Many of its provisions still relied on the NRSROs' self-compliance. It reduced conflicts of interest but did not eliminate the problem completely. As a result, the passage of the Reform Act was too little and too late to provide a substantive improvement to prevent the Financial Crisis.

Dodd–Frank Wall Street Reform and Consumer Protection Act 2010

The Dodd–Frank Wall Street Reform and Consumer Protection Act in 2010 is the much-hoped-for regulatory instrument that developed after the Crisis to correct the conflicts of interest. Nonetheless, the Congress's initiative had not been acted upon or had not been fully implemented by the SEC,[69] ie, failing to adopt an alternative system to improve the 'issuer-pay' business model. Hence, to some extent, the Dodd–Frank Act is an opportunity missed in dealing with the conflicts of interest and the rating inflation issue of CRAs.

The Dodd–Frank Act imposed several requirements for NRSROs to reduce conflicts of interest, including new rules to prevent the sales and marketing considerations of NRSROs from influencing the production of credit rating and the 'look-back' policy.[70] Regarding the former, the Dodd–Frank Act signifies the separation and prohibition of any persons sitting on the marketing and/or management boards from influencing the rating decisions of the credit analysts and the rating methodologies development for market and economic considerations and vice versa.[71] It encompasses the situation whereby the manager inappropriately influences the employees who are involved in credit ratings or developing the rating methodologies.[72] The SEC took a strict interpretation of this rule, the breach of which would lead to sanctions such as suspension or revocation of the NRSROs' registration.[73] This rule reduces the chance of the management board pressurizing key analysts,

68 Legislative Attorney (n 55) 1.

69 Scott J Boylan, 'Credit Rating Agencies Reform: Insight from the Accounting Profession' (2011) 81 (11) The CPA Journal; New York 40–3, 40, Boylan stated that '[b]udgetary issues and political wrangling at the federal level have thus far delayed many of the [Congress] initiatives'.

70 Pub L No 111-203, s 932(a)(4) (The Dodd–Frank Act); 15 USC s 78o-7(a)(4).

71 17 CFR s 240.17g-5(c)(8), the SEC's final rule prohibited NRSROs from 'issuing or maintain a credit rating where a person with the NRSRO who participates in determining or monitoring the credit ratings, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative and quantitative models, also: (1) participates in sales or marketing of a product or service of the NRSROs or product or service of an affiliate of the NRSROs; or (2) is influenced by sales or marketing considerations'.

72 SEC, 'Nationally Recognised Statistical Rating Organisations—final Rules' (2014) 17 CFR Parts 232, 240, 249 and 249b, 101.

73 15 USC 78o–7(h)(3)(B)(ii); SEC ibid 101.

resulting in the impairment of their professional judgement for commercial considerations when developing rating methodologies and assigning credit ratings. To some extent, it reduces the conflicts of interest which derive from the 'issuer-pay' business model.

With regard to the latter, NRSROs must have a look-back policy to assess any conflicts of interest that the employee of an issuer, obligor, underwriter subject to a credit rating of the NRSROs, was employed by the NRSROs and participated in determining such a rating during the 1-year period.[74] The 'look-back' provision imposes detailed guidance on NRSROs to review, promptly revise and disclose credit ratings which were influenced by conflicts of interest. [75] This provision aims to eliminate the conflicts of interest springing from analysts who take employment from issuers within a year of the termination of their employment with NRSROs.[76] It deals with the 'revolving door' problem which became a public policy concern, particularly where transitioning analysts inflate issuers' ratings for the purpose of securing lucrative employment with the same issuers afterwards.[77] It should increase transparency and the integrity of the CRAs' rating process and alert the potential risk of using the NRSROs' ratings for investment decisions.[78]

After the implementation of the SEC's final rules in 2014,[79] the Office of Credit Ratings' (OCR) summary report revealed a great deal of issues regarding the management of conflicts of interest acutely existing in several NRSROs. These defects include a lack of sufficient policies, procedures, and controls to manage the issuer-paid conflicts or to prevent the analytical persons' access to fees or market-share information, to prevent prohibited, unfair, coercive or abusive practices, and to control certain conflicts of interest or to sufficiently disclose such conflicts of interest.[80] The report identified significant weaknesses existing in the monitoring, investigation or disclosure of conflicts of interest and in the securities ownership policies, procedures and controls.[81] The activities which would otherwise constitute conflicts of interest prohibitions still widely existed in the NRSRO's business activities, including the senior analysts communicating fee information to clients or potential clients and engaging in sales and marketing activities.[82]

Despite these, the various breaches mentioned in the OCR's summary report did not lead to any suspension and revocation of the NRSRO's status but merely improvement recommendations from the OCR staff, contrary to the SEC's strict interpretation for breaching

74 Pub L No 111-203, s 932(a)(4); 15 USC s 78o-7(a)(4); RMI Staff Article, 'A New Regulatory Framework for Credit Rating Agencies' (13 May 2010) Global Credit Review, 16.

75 17 CFR s 240.17g-8(c); 17 CFR s 240.17g-7(a)(1)(ii)(J)(3)(i).

76 Pub L No 111-203, s 932(a)(4).

77 Jess Cornaggia, Kimberly J Cornaggia and Han Xia, 'Revolving Doors on Wall Street' (2014) 120 Journal of Financial Economics 400–19, 401.

78 SEC (n 72) 147.

79 Ibid 1 and 2.

80 SEC, '2015 Summary Report of Commission Staff's Examinations of Each Nationally Recognised Statistical Rating Organisation, As Required by Section 15E(P)(3)(C) of the Securities Exchange Act of 1934' (December 2015) <https://www.sec.gov/files/2017-02/nrsro-summary-report-2015.pdf> accessed 5 September 2021, 15–17.

81 Ibid.

82 Ibid.

Rule 17 g-5(c)(8).[83] The legal effect of the SEC's final rules should be authoritative and carries legal weight when breached. The NRSROs' compliance lagged due to the fact that the SEC may have no intention of imposing suitable sanctions. Hence, it is doubtful whether the regulators and the parties concerned have the will to carry out the rules and to achieve the intended purposes. For now, conflicts of interests remain as an acute problem with NRSROs.

Feasible business model

Undoubtedly, the 'issuer-pay' business model is the root cause of conflicts of interest, ie, the 'disease'. Notwithstanding, simply switching from 'issuer-pay' to 'subscriber-pay' is not necessary for the solution of conflicts of interest. The 'subscriber-pay' model can also cause conflicts of interest in addition to the informational asymmetries problem. The subscribers can exert pressure on NRSROs to determine or maintain credit ratings in favour of subscribers.[84] Additionally, both the 'subscriber-pay' and the 'investor-pay' model can cause an information shortage in the financial market, exacerbating informational asymmetries and freeriding public goods.[85] The 'investor-pay' model has limited welfare improvements and may be hard to implement from a practical perspective.[86]

Section 939F(b) of the Dodd–Frank Act requires the SEC to assess the feasibility of establishing a system, in which a public or private utility of a self-regulatory organization assigns NRSROs to determine the credit ratings of SFPs.[87] Following the findings and recommendations of the assessment, the SEC shall establish a system for assigning NRSROs to determine the initial credit ratings of SFPs.[88] This promulgation intends to address the issue of conflicts of interest arising from the 'issuer-pay' and 'subscriber-pay' models and address the root cause of the problem.[89] Following section 939F(b), a self-regulatory organization assigning NRSROs could prevent issuers or subscribers from choosing NRSROs and exerting pressure for more favourable ratings. The US Congress gave clear instructions that the SEC either determines an alternative system which would better serve the public interest or implements the section 15E(w) model of the Securities Exchange Act of 1934.[90] Nonetheless, to date the SEC has not implemented any alternative compensation model or system in accordance with the congressional intention, with the result that the S939F did not have any real impact in dealing with conflicts of interest. The regulators showed little intention of developing these models as the SEC did not reach out for further discussion.[91]

83 Ibid.

84 SEC, 'Report to Congress on Assigned Credit Ratings, As Required by S939F of the Dodd–Frank Wall Street Reform and Consumer Protection Act' (2012) <https://www.sec.gov/news/studies/2012/assigned-credit-ratings-study.pdf> accessed 5 September 2021, 16.

85 Partnoy (n 17) 654; Skreta and Veldkamp (n 4) 21.

86 Eurosystem, 'Alternatives for issuer-paid Credit Rating Agencies' (2014) European Central Bank, Working Paper Series No 1703/August, 6.

87 15 USC 78o–9(b).

88 15 USC 78o–9(d).

89 Ibid.

90 15 USC 78o–9(d)(1).

91 GAO (n 10) para 'What GAO Found' 7.

The inaction of the SEC sits uncomfortably with the aim of the US Congress which intends to impose tough measures to correct the conflicts of interest and the rating inflations of CRAs.

Franken Amendment and Random Selection Model

According to the US Government Accountability Office (US GAO), the Franken Amendment/Random Selection Model is the most favoured model, although commentators did not reach any agreement on the adoption of the section 15E(w).[92] No other alternatives would offer more benefits than the Franken Proposal without overburdening the NRSROs and causing the NRSROs to reject the registered status.[93] Under this model, the clearinghouse randomly assigns NRSROs to rate issuances in order to protect the public interest and investors.[94] The clearinghouse becomes the only point of contact between issuers and NRSROs in terms of selection, information supplying, payments for ratings, administration costs and designing selection criteria. According to the GAO's report, the clearinghouse should be an independent, non-profit governmental agency or a private–public partnership, which can design criteria to select the NRSROs. This body is responsible for determining fees for the initial ratings and maintenance ratings. In terms of promotion on the competition and rating standard, this model is accompanied by a peer comparison review system so to reflect the performance of NRSROs and to impose sanctions based on two empirical tests, eg, the default percentage of debt instruments of NRSROs in general and the annual yields of identical debt classes.[95]

Despite this, the Franken Amendment/Random Selection Model has its own defects. The criticism of the Franken Amendment rule includes reducing competition, curbing innovations[96] and its ineffectiveness in countering rating inflation as investors may select CRAs for the purpose of maximizing market shares and catering for issuers' preferences.[97] Some critics suggested that the clearinghouse may not be suitable for the assignment and may be biased towards the 'Big Three'.[98] Since the clearinghouse is a non-profit organization, it is unlikely the selecting process will favour any NRSROs at the cost of public interest. The selection criteria to assess the rating NRSROs can be easily established because of the increased requirement of the rating performance disclosure from NRSROs under the Reform Act and the Dodd–Frank Act. The current disclosure requirement should assist the clearinghouse to design a logical and fair selecting system, which can promote competition and rating standards. At the same time, the Franken Amendment/Random Selection Model should work to reduce the conflict of interest and rating inflation with balanced cost efficiency. The evaluation on these points are as follows.

92 Ibid 1.
93 Jason W Parsont, 'NRSRO Nullification: Why Ratings Reform May BE in Peril' (2012) 77 Brooklyn Law Review 1071.
94 GAO (n 10) para 'What GAO Found,' 8–9.
95 GAO (n 10) 8–9.
96 RMI Staff Article (n 74) 16.
97 Eurosystem (n 86) 9.
98 Parsont (n 93) 1058.

The clearinghouse and the increased transparency

The Reform Act already requires the annual disclosure of performance measurement statistics over short-term, middle-term and long-term periods.[99] This disclosure requirement was criticized for not prescribing the methodologies for calculating the performance statistics, the format and the type of information for disclosure.[100] Since NRSROs used different methods to calculate performance statistics, the disclosed information would have limited comparability.[101] Compared to the Reform Act, the Dodd–Frank Act increased the transparency of CRAs by the imposition of compulsory disclosure requirements. One of these key requirements is that NRSROs must publicly disclose the initial ratings and any subsequent changes.[102] They must disclose the main assumptions and principles used in constructing procedures, methodologies and assumptions about the correlation of defaults across underlying assets used in rating structured products.[103] The Act specifies that the disclosed information must be comparable, clear and informative for a wide range of investors.[104] In addition, the NRSROs must also disclose the information about the reliability, accuracy and quality of data in determining the credit rating, the limitations on the scope of historical data and the limitations on the accessibility of other information.[105] Although the SEC did not require a full disclosure of the underlying data that NRSROs relied on to arrive at their credit ratings for SFPs, the current scope of disclosure could prevent NRSROs from applying lax rating standards based on unreliable, inaccurate and insufficient data, hence improving their rating standards. It should also give forewarning to investors if credit ratings relied on limited historic or insufficient data.

More performance statistics disclosures should increase the transparency of the CRAs' performance and enhance their performance since the disclosure would flag up poor workmanship. To some extent, increased disclosures should persuade NRSROs to avoid conflicts of interest and rating inflation. Previously NRSROs must provide performance statistics for each class of credit ratings for which the applicant is seeking registration or if the NRSRO is already registered.[106] The SEC's final rule divided the broad classes of SFPs into subclasses, such as residential mortgage-backed securities (RMBSs), commercial mortgage-backed securities (CMBSs), collateralized loan obligations (CLOs), CDOs, asset-backed commercial papers (ABCPs) and other asset-backed securities (ABSs).[107] The

99 15 USC s 78o-7(a)(1)(B)(i).

100 GAO, 'Securities and Exchange Commission: Action Needed to Improve Rating Agency Registration Program and Performance Related Disclosures' (September 2010) Report 10-782, 27–37, 'The GAO found that the variability in how NRSROs produce performance statistics limited the ability of investors and other users of credit ratings to compare the performance of credit ratings across NRSROs'; SEC (n 72) 172–3.

101 Ibid; SEC (n 72) 172–3.

102 Pub L No 111-203 s 932(a)(8), adding (q)(1); 15 USC 78o-7(q)(1).

103 Pub L No 111-203 s 932(a)(8), adding (s)(3); 15 USC 78o-7(s)(3).

104 Pub L No 111-203 s 932(a)(8), adding (q)(2)(A)&(B); 15 USC 78o-7(q)(2)(A)&(B).

105 Pub L No 111-203 s 932(a)(8), adding (s)(3)(A)(iv)(II); 15 USC 78o-7(s)(3)(A)(iv)(II).

106 SEC (n 72) 170.

107 SEC, 'Application for Registration as a Nationally Recognised Statistical Rating Organisation (NRSROs),' paras (1)(D)(i) through (vii) of the instructions for Exhibit 1, Form NRSROs <https://www.sec.gov/about/forms/formnrsro.pdf> accessed 12 March 2019, 21–5.

additional information should provide useful and comparable statistics for investors.[108] In particular, the NRSROs' performance for SFPs was severely controversial and opaque for most investors during the last Crisis. As a result, this information should assist the evaluation of the NRSRO performance for the clearinghouse.

In order to improve comparability, the SEC prescribed the presentation of the performance statistics in the form of the Transition/Default Matrices.[109] It prescribed the methods of calculating the performance statistics and Transition/Default Matrices for displaying information.[110] A unification of calculating methodologies and presentation formats can increase transparency, comparability and the understanding of credit ratings for a wide range of investors. In this sense, a simple straightforward compatible Matrix should help the smaller NRSROs to gain visibility. At the same time it can promote competitiveness and the performance standard because any malpractice is likely be discovered by investors and regulators. With the additional information the clearinghouse should be in a better position to design the selecting criteria and to impose penalties if the rating NRSROs fall below the standard.

Mitigating 'issuer-pay' conflicts with balanced cost efficiency

The Franken Amendment/Random Selection Model should effectively mitigate the 'issuer-pays' conflicts, henceforth to deal with the rating-shopping problem.[111] The essence of the clearinghouse selection plus an indirect remuneration by issuers does not deviate from the current 'issuer-pay' model as the issuers would still be the paying party and the administration fees incurred by the clearinghouse, but paying directly to the clearinghouse. Hence, it solves the thorny issue of a complete overhaul of the existing business model, which could overburden the rating industry. Despite this, commentators raised the issue that the implementation of the S15E(w) model would incur significant cost for the additional staff with specialized skills and the extensive amount of infrastructure for the smooth operation of this body.[112] In terms of additional staff and infrastructure, the SEC has already obtained the reprogram funds and duly established the Office of Credit Ratings in 2012, which carries out the functions of overseeing the NRSROs' compliance, promoting accuracy in credit ratings and conducting annual examinations of each NRSRO.[113] Therefore, this office should be well-equipped with specialized staff and suitable infrastructure to carry out the clearinghouse's selecting function alongside other administrative roles.

The additional administrative cost should be duly paid by the issuers through rating fees, although this cost is likely to be factored into the cost of investments for investors. Hence, the Franken Amendment/Random Selection Model could increase extra financial burdens for the issuers and the investing public. Nonetheless, the positive effect of this

108 SEC (n 72) 179.
109 SEC (n 107) paras (2) and (3) of the instructions for Exhibit 1.
110 Ibid para (4)(B) of the instructions for Exhibit 1; SEC (n 72) 184.
111 GAO (n 10) 9
112 GAO (n 10) 17.
113 GAO (n 10) 24; SEC, 'Office of Credit Ratings' (2017) <https://www.sec.gov/page/ocr-section-landing> accessed 15 October 2021.

model should outweigh the additional cost. In general, returning to the 'investor-pay' model cannot achieve the optimum outcome in terms of reducing conflicts of interest and generating sufficient revenues as well as informational value for the rating industry.[114] Hence, the most important aim for regulators should be to create a system, which can improve the rating quality and increase the trust of investors on credit ratings in order to eliminate the 'lemons' in the debt market and to enhance market efficiency.[115] The cost efficiency of the new model is analysed from these two contrasting perspectives, ie, the important information intermediary role of CRAs in the financial market and the negative impact of the CRAs' catastrophic failure during the last Financial Crisis.

First, CRAs also play the role of bridging the gap of the information asymmetries.[116] Credit ratings provide an evaluation on the creditworthiness of issuers and issues, the creditworthiness of which is then codified into ratings to indicate the level of risks associated with different bond securities. Credit ratings have informational value and impact on the capital market, although CRAs fell short in fulfilling the informational role because of the continued deterioration in their informational value. Information asymmetries was an issue recognized in the financial market for a long time.[117] In the structured financial market, the borrowers and the issuers have more information than lenders on the pools of assets, securities structures and their collaterals. The issuers of lower quality products can exploit the financial market due to information asymmetries. Studies showed that the information holders can withhold information in order to achieve high returns for low-quality products, ie, 'lemon' products can be sold at the same price as good quality products.[118] As a result, the moral hazard issue can rise when sellers try to make more profit by choosing to withhold information.[119] Additionally, informational asymmetries can lead to a market failure. [120] The worst case scenario is that it can lead to no market existing at all and no goods will be traded at any price level due to the fall in the product's quality.[121] For SFPs, informational asymmetries can drive the price and quality of securities products down as the investors cannot differentiate between the good quality products and the 'lemons'.

CRAs 'pierce the fog of asymmetric information by offering judgments'[122] about the credit quality of the issues. Being the informational intermediaries, CRAs grade the debt instruments according to their quality. Lenders or sellers of securities with more favourable characteristics would be incentivized to solicit informational intermediaries.[123] Likewise,

114 Christoph Buhren and Marco Pleßner, 'Rating Agencies—An Experimental Analysis of their Remuneration Model' (2015) 16 (3) German Economic Review 324–42, 339.

115 Ibid 339.

116 Partnoy (n 17) 633.

117 Hayne Leland and David Pyle, 'Informational Asymmetries, Financial Structure and Financial Intermediation' (1977) XXXII (2) Journal of Finance 371.

118 Ibid 371; George Akerlof, 'The Market for "Lemon": Quality Uncertainty and the Market Mechanism' (1970) 84 (3) Quarterly Journal of Economics 488–500, 489.

119 Leland and Pyle (n 117) 371.

120 iIbid.

121 Akerlof (n 118) 491.

122 White (n 3) 212.

123 Leland and Pyle (n 117) 384.

issuers can use credit ratings to show the above-average quality products.[124] Thus, credit ratings can send a signal for investors as to which bonds are more likely to default than others. With more information available, investors would be able to make well-informed investment decisions, in return, achieving high prices for the securities and more profits for issuers. Hence, given the important role of CRAs, the issuers should be willing to pay for the rating fees in order to achieve better returns.

Secondly, CRAs failed their informational intermediary role catastrophically during the last Financial Crisis. CRAs performed poorly on structured products with many products too highly rated or inflated, resulting in the CRAs' initial ratings suffering from severe downgrading.[125] Credit ratings for structured products were inflated prior to the Crisis, resulting in the loss of credit risk information in the securities market. AAA rated structured finance securities suffered from significant downgrades, ie, the total percentage was 31 per cent of all downgrades in 2008.[126] The degree of optimism in the CRAs' ratings can also be reflected in the percentage of downgrades for SFPs: 90 per cent of the residential mortgage-backed securities issued in 2006 and 2007 were downgraded from an investment grade rating to junk bond status by S&P and Moody's.[127] The downgrading AAA rated products had a significant impact on the insurance companies, banks and money market funds. First, the downgrading of major insurance companies suffered the biggest write-downs, such as the write-down in AIG which was $66.943 billion.[128] As the downgrade of AAA rated securities reached 31 per cent of all downgrades,[129] the insurance companies would have had to downgrade and sell off many of their holdings. Secondly, the downgrading of AAA ratings forced money-market funds to sell their underlying assets, resulting in triggering a run on the money-market funds, such as the bankruptcy of Lehman Brothers in 2008.[130] Given the huge social and economic damages caused by the CRAs' rating downgrading during the Financial Crisis, dealing with the conflicts of interest and rating inflation of CRAs should be a pressing issue on the agenda for regulators in the post-Crisis era in order to refurnish the trust of the investing public. As a result, the Franken Amendment/Random Selection Model should have a significant role to play to improve the stability of the financial market. In this case, the overall benefits of this model should outweigh the added cost for issuers.

Three improvements of the Franken Amendment/Random Selection Model

Having established the feasibility of the Franken Amendment/Random Selection Model, regulators should refine this model in three ways. First, the selection committee must be an

124 Coffee (n 2) 288.

125 Benmelech and Dlugosz (n 42), 175, 178, The number of downgrades of SFPs increased rapidly from 2006 to 2008, which peaked in 2008; the total percentage of the SFP tranches affected by downgrades were 7.2% in 2007 and 6.7% in 2008, increasing significantly compared with 1.4% in 2005 and 1.2% in 2006. These figures suggested that credit ratings for structured products were inflated prior to the Crisis.

126 Benmelech and Dlugosz (n 42) 178–9.

127 White (n 3) 221; GAO (n 10) 1.

128 Pagano and Volpin (n 7) 404; Benmelech and Dlugosz (n 42) 163.

129 Benmelech and Dlugosz (n 42) 178–9.

130 Gary B Gorton, 'The Panic of 2007' (2008) National Bureau of Economic Research, Working Paper 14358, September 2008, 14.

independent body. The selection committee should comprise a wide range of independent experts, eg, private analysts, investors, issuers, auditors and bankers, etc. A combination of members can cater for all angles of consideration while avoiding economic and politic biases. This article identified that the OCR under the supervision of the SEC should be a suitable organization to fulfil this function and to develop the selection criteria. In addition to considering the CRAs' historic performance statistics, the clearinghouse should develop selection criteria, which should include but not be limited to the factors of the credit analysts' and supervisors' ratios, the CRAs' institutional and technical capacity test and the merit-based track records.[131]

Secondly, regulators can impose an additional disclosure requirement for justification for departures from the quantitative model. Jollineau et al's study suggested that combining the 'investor-pay' model and the requirement for analysts to justify a rating which departed from the quantitative model can effectively address the conflicts of interest and rating inflation issue.[132] The requirement of justification for a deviation can also be helpful in resolving the conflicts of interest if the current 'issuer-pay' model remains dominant. Currently, the disclosure of justification for departures from the quantitation model are not specified under the current disclosure requirements under the US law. NRSROs must disclose the version of a credit rating procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating.[133] The NRSROs must disclose detailed information pertaining to the material changes on their corporate internet website, including the reasons for the changes, the likelihood of changes to any current credit ratings, and any significant errors.[134] These two disclosure requirements are applaudable for eliminating the opaqueness existing in the NRAROs rating methodologies. It can increase credit rating users' insight on the 'black box' and enhances their understanding of credit ratings. The users would also be forewarned about the material changes and significant errors to the rating methodologies and any impact which they entail. The additional disclosure on the methodologies and any material changes or errors of the methodologies should close the informational gap for the second improvement in accordance with Jollineau et al's study, although they do not go far enough to cover the justification for departures from the quantitative model.

Moreover, section 932(a)(8) of Dodd–Frank Act imposed a third-party due diligence provision for asset-backed securities. The issuers and underwriters of ABS must publish the findings and conclusions of any third-party due diligence report.[135] Upon issuing the third-party due diligence certification, the third-party must be satisfied that any NRSRO conducted a thorough review of data, documentation and other relevant information

131 Parsont (n 93) 1061–2.

132 S Jane Jollineau, Lloyd J Tanlu and Amanda Winn, 'Evaluating Proposed Remedies for Credit Rating Agency' (2014) 89 (4) The Accounting Review 1399–420, 1402.

133 15 USC 78o-7(r)(5); para (a)(5) of Rule 17g-8.

134 15 USC 78o-7(r)(4).

135 15 USC 78o-7(s)(4)(A).

necessary for a NRSRO to provide an accurate credit rating and produced a credit rating with due diligence.[136] This means the third-party provider would have reviewed and satisfied the assets underlying an ABS regarding the accuracy of the information or data provided by the securitizer or originator, whether the origination of the assets conforms to or deviated from various standards and requirements, the value of the collateral securing assets, whether the originator of the assets complied with relevant laws, and any other factors or characteristic of the assets that would be material to the likelihood of the issuer's repayment.[137] The review process looks into the underlying asset data, the origination standards and legality, the value of the collaterals and any other material characteristic of the assets for determining the issuer's repayment ability. Therefore, this evaluation offers a relatively comprehensive insight into the quality, integrity and standards regarding the origination of ABSs. Although the disclosure of the justification for departures from the quantitative model and the rating process is not specified, the third-party due diligence report should act to satisfy the second improvement, albeit through in-direct means.

Nonetheless, pushing for direct disclosure should still be necessary. The OCR's summary report revealed several major concerns in the area of adherence to policies, procedures and methodologies in 2015. For example, one NRSRO did not code the quantitative model for initial ratings of a structured finance transaction, resulting in over-optimistic ratings.[138] The same NRSROs failed to apply certain assumptions and methodologies to the correct products for the correct purpose.[139] Other defects consisted of senior rating personnel intervening in the rating process and rating appeals, failing to disclose errors in calculations, inaccurate methodology disclosure and applying unapproved methodologies.[140] All these defects contravened the NRSROs' internal policies and procedures, impeding the NRSROs' proper performance. NRSROs can fall below the prudence standard if non-compliance exists. In terms of eliminating conflicts of interest and rating inflation, regulators need to enhance the compliance of existing disclosure requirements and, at the same time, to extend the disclosure requirement to cover the justification for departures from the quantitative model.

Lastly, the third improvement is to adopt the double rating rule along with the Franken Amendment/Random Selection Model. Bolton's solution for informational asymmetries and an improved rating efficiency is to create a regulated duopoly with regard to the problems of conflicts of interest and rating shopping.[141] The regulated duopoly requires issuers to purchase a rating from two CRAs, hence, the mandatory double rating requirement.[142] Double ratings should force CRAs to assign ratings with due care since any wrong ratings assigned recklessly or under the influence of conflicts of interest would be collated against

136 15 USC 78o-7(s)(4)(C); 17 CFR 240.17g-10(a).
137 17 CFR 240.17g-10(d).
138 SEC (n 80) 11.
139 Ibid 11 and 12.
140 Ibid 11–13.
141 Bolton et al (n 33) 102.
142 Ibid 103.

the second rating. Under this model CRAs would rate truthfully based on the maximum available information because the purchase is no longer contingent on the final ratings.[143] Noteworthily, the regulated double-rating model was adapted in the EU's Regulation No 462/2013. The feasibility of the double-rating rule is evaluated in the section 'Mandatory double rating rule'.

Increased influence of CRAs post financial crisis

Despite various reforms, criticism continued to exist regarding their system structure and industry standards. The SEC kept strict surveillance on the NRSROs' performance after the Crisis, which led to historical fines and settlements, such as Moody's $130 million settlement with a California pension fund in 2016 and S&P's nearly $1.4 billion penalty with the US Justice Department and a one-year suspension from rating certain bond deals in 2015.[144] The SEC passed two orders in 2018 against Moody's, which failed to follow its internal control procedures, to clearly define and to consistently apply credit rating symbols.[145] Moreover, the SEC issued three orders instituting settled administrative proceedings against the S&P in 2015 for various violations and fraud.[146] According to the SEC the S&P demonstrated a 'race to the bottom' behaviour and lowered the standards in pursuit of market shares.[147] The SEC heavily criticized S&P for 'reflect[ing] a deep cultural failure and a failure to learn the lessons of the Financial Crisis'.[148] Clearly, more work needs to be done in terms of the improvement of industry governance and rating performance. Accordingly, failing to adopt a robust legal framework to address the conflicts of interest by the SEC have a significant impact on the rating system, particularly when the most influential CRAs are all US-based and are subject to the jurisdiction of the Dodd–Frank Act.

Moreover, despite on-going criticism, the whole rating industry gained more momentum in recent years. The 'Big Three's profits almost reached all-time highs by 2016 and continued to assign the majority of outstanding ratings'.[149] The CRAs developed a new role, ie, a combination of a traditional 'financial gatekeeper' and a 'gateway constructor'.[150] Regarding the latter, CRAs created a language that allowed the rated organization to communicate with the global financial market; it created a basis that credit default risks could be calculated by actors in the global financial market.[151] The CRAs' metrics in the rating methodologies were internalized by the House Associations (HAs) and led to a dramatic

143 Ibid.

144 Timothy W Martin, 'What Crisis? Big Ratings Firms Stronger Than Ever' (2016) The Wall Street Journal <https://www.wsj.com/articles/what-crisis-big-ratings-firms-stronger-than-ever-1457655084> accessed 20 August 2021.

145 SEC, 'SEC Charges Moody's with Internal Controls Failures and Rating Symbol Deficiencies' (2018) <https://www.sec.gov/news/press-release/2018-169> accessed 5 September 2021.

146 SEC, 'SEC Announces Charges against Standard & Poor's for Fraudulent Ratings Misconduct' (2015) <https://www.sec.gov/news/pressrelease/2015-10.html> accessed 5 September 2021.

147 Ibid.

148 Martin (n 144).

149 Ibid; SEC (n 11) 10.

150 Stewart Smyth, Ian Cole and Desiree Fields, 'From Gatekeepers to Gateway Constructors: Credit Rating Agencies and the Financialisation of Housing Associations' (2020) 71 Critical Perspectives on Accounting 102093.

151 Ibid 18.

increase of the operating margin from 21.1 per cent in 2010 to 30.5 per cent in 2015.[152] The HAs took the liberty of incorporating the CRAs' metrics in their own system before formally engaging a CRA for ratings. The CRAs' rating metrics had great significance for the housing industry, such as the HAs which went a long way to change their internal languages and existing financial measures used to monitor performance.[153] Therefore, not only do the CRAs remain key—with their added role of 'gateway constructor'—to the global financial market, their published rating methodologies continues to play an important role in terms of facilitating the private finance sector, in this case, the housing sector. While defects and malpractice continue to exist among the international CRAs, the increased importance of the CRAs' ratings in the global financial market can be problematic, particularly if the private finance sectors decided to internalize the CRAs' rating metrics for the purpose of matching-up with the CRAs' rating criteria in order to obtain higher ratings.

In short, the Dodd–Frank Act made several attempts to reduce conflicts of interest. Some are more effective than others. The separation of marketing and management teams form analysing activities, and the look-back policies are well thought-out and meaningful provisions, since the breach of them could lead to disciplinary procedures against NRSROs. The US's approach is criticized for not going far enough because it requires CRAs to implement policies designed to limit the interaction of the management and marketing teams from analysis activities.[154] Both the Reform Act and the Dodd–Frank Act contain provisions which still depend on the CRAs' self-compliance. This can lead to uncertainty as to their effectiveness.[155] The impact of the Dodd–Frank Act in this regard is limited because many NRSROs disregarded the established policies and the SEC lacked the willingness to impose stringent sanctions on NRSROs. Lastly, the SEC ignored the US Congress's intention and failed to adopt a viable system to combat the conflicts of interest. Compared to the EU's provision, the Dodd–Frank Act took a 'light touch' approach in dealing with the regulation of the CRAs' business model.[156] The Franken Amendment/Random Selection Model with the suggested improvement can provide a feasible alternative to dealing with the conflicts of interest issue, while avoiding a drastic overhaul of the current 'issuer-pay' business model.

5. EU regulation

Regulation on CRAs (EU) No 1060/2009

Following suit, the EU regulators took several steps to deal with the conflicts of interest of the CRAs. Regulation on CRAs No 1060/2009 was the first regulation of the EU to impose provisions to reduce conflicts of interest. It also imposed specific organizational and operational requirements for CRAs. A CRA shall have an independent administrative or

152 Ibid 12.

153 Ibid.

154 Boylan(n 69) 42; 17 CFR s 240.17g-5(c)(8).

155 EC, 'Study on the State of the Credit Rating Market-Final Report' (2016) Market/2014/257/F4/ST/OP, 78.

156 Andrea Miglionico, 'The US Regime,' *The Governance of Credit Rating Agencies, Regulatory Regimes and Liability Issues* (Edward Elgar Publishing 2019) 126.

supervisory board to ensure that its business interest does not impair the independence or accuracy of credit rating activities.[157] Notably, the provision does not impose a direct ban on ancillary services as long as these services do not present conflicts of interest with rating activities.[158] Similar to the US law, it emphasized the CRAs' self-management and disclosure in dealing with conflicts of interest. Moreover, CRA Regulation No 1060/2009 prohibits the CRA from making proposals or recommendations for the designing of SFPs if the same CRA will rate the instrument.[159] This provision reduces the acute conflict of interest existing in situations whereby CRAs participated in the designing of SFPs for which the same CRA would later assign a rating.

Furthermore, Article 7 of the CRA Regulation No 1060/2009 implements several measures to deal with conflicts of interest and to improve the rating quality. It prohibits analysts from initiating or participating in negotiation fees with any rated entity,[160] which is a provision similar to the US rule 17 g-5(c)(8), ie, the separation of the managing and marketing teams from the analytical team.[161] This separation should enhance analysts' independence for credit risk assessment.

Article 7(3) CRA Regulation No 1060/2009 requires CRAs to establish an appropriate gradual rotation mechanism for analysts and persons approving credit ratings.[162] The rotation rule should reduce the chance of collusion by the analyst who approves and assigns the ratings, resulting in a better quality of performance.[163] Additionally CRA Regulation No 1060/2009 prohibits credit analysts from taking up a key management position with the rated entity within six months of the credit ratings.[164] Compared with the 'look-back' policy, the analysts' rotation policy has a prominent effect in breaking the links between the analyst's current influence and the potential lucrative position with issuers. Article 7 is therefore likely to improve the professionalism of rating analysts, reduce conflicts of interest and the avoid future erosion of quality among CRAs.[165]

Regulation on CRAs (EU) No 462/2013

CRA Regulation No 462/2013 represents the most comprehensive legislation on CRAs in the EU and addresses the conflicts of interest issue. Compared to the US system it has a tougher approach and constitutes a more successful reform in general, although shortcomings still exist. It took several steps to improve the independence and integrity of CRAs and reduced conflicts of interest including the shareholding limitation rules and the 4-year mandatory rotation rule. Unlike the US law, EU regulators did not directly deal with the

157 Regulation (EU) No 1060/2009, Annex I, S(A)(1) and (2).

158 Regulation (EU) No 1060/2009, Recitals (2) and (6); Thomas MJ Mollers, 'Regulation and Liability of Credit Rating Agencies—A More Effective European Law' (2014) 11 (3) European Company and Financial Law Review 333–63, 338.

159 Regulation (EU) No 1060/2009, Annex I, S(B)(5).

160 Ibid art 7(2).

161 17 CFR s 240.17g-5(a)(8).

162 Regulation (EU) No 1060/2009, art 7(3).

163 EC (n 155) 78.

164 Regulation (EU) No 1060/2009, Annex I, s C(7).

165 EC (n 155) 81–2.

conflicts of interest by changing the 'issuer-pay' business model, but by implementing provisions to avoid conflicts of interest. Under the EU law, CRAs must take all necessary steps to ensure that potential conflicts of interest or business relationships do not affect the issuing of credit ratings and/or a rating outlook.[166] CRAs shall also establish an effective internal control structure to prevent and mitigate possible conflicts of interest.[167] Both provisions depend on the CRAs' self-compliance. This can lead to uncertainty as to their effectiveness, particularly when rating the more complex SFPs should CRAs comply with them superficially.[168]

Shareholding limitation rules

Article 6a CRA Regulation No 462/2013 constitutes one of the new provisions to eliminate the influence of shareholders on the rating activities of more than one CRA by imposing a shareholding limitation rule. It prohibits shareholders who hold at least 5 per cent of capital or voting rights in an agency from holding 5 per cent or more shareholdings or voting rights in another CRA unless CRAs belongs to the same group.[169] CRAs must not rate when a shareholder of a CRA with 10 per cent or more shareholdings or voting rights also holds 10 per cent or more of a rated entity.[170] These shareholding limitation rules should increase the independence of CRAs from being influenced by the rated entities while at the same time reducing collusion among CRAs.[171] Kedia et al's study showed that Moody's produced more favourable ratings for larger issuers of SFPs and for those with more conflicts of interest.[172] Moody's had a 'tangible bias' in favour of its two largest shareholders.[173] Therefore, the shareholding prohibition is a necessary measure to reduce the influence of powerful shareholders on CRAs.

Regulators held the view that Article 6a, the 5 per cent shareholding limitation rule, may have a long-term positive impact on independence and quality of credit ratings with limited implementation costs, although issuers and investors suggested the impact of this provision has been minimal.[174] This rule can be less effective for the reduction of the shareholders' influence on CRAs because the 5 per cent shareholding limitation rule does not apply if CRAs belong to the same group.[175] The 'Big Three' owns more than half of the CRAs operating in Europe and takes 93.4 per cent of the market shares in the EU.[176] Hence, half of the CRAs in the EU will not be affected. In contrast, the US law did not

166 Regulation (EU) No 462/2013, art 1, S(7)(a).
167 Ibid S(7)(c).
168 EC (n 155) 78.
169 Regulation (EU) No 462/2013, art 1, S(8), Asserting art 6a(1)&(2) in Regulation (EU) No 1060/2009.
170 Ibid S(1)(b).
171 EC (n 155) 77.
172 Simi Kedia, Shivaram Rajgopal and Xing Zhou, 'Did Going Public Impair Moody's Credit Ratings?' (2014) 114 (2) Journal of Financial Economics 293–315, 294.
173 EC (n 155) 76; Tracy Alloway, 'Moody's in New Conflict of Interest Claim', *Financial Times* (30 July 2014).
174 EC (n 155) 80–1.
175 Regulation (EU) No 462/2013, art 1, S(8), Asserting art 6a(1)&(2) in Regulation (EU) No 1060/2009.
176 Mollers (n 158) 342; EC (n 155) 80–1.

impose any provisions to limit the shareholder's influence. Likewise, the 5 per cent shareholding limitation rule can have a small impact if it does not apply to CRAs belonging to the same group. Data in 2013 showed that more than 45 per cent of all agencies are affiliated with a group worldwide and establishing group affiliation is a strategy used by big CRAs to enhance their competitiveness.[177] The respective market shares for the 'Big Three' in terms of total global outstanding credit ratings were S&P 50.1 per cent, Moody's 32.0 per cent and Fitch 13.0 per cent, while the other CRAs hold less than 10 per cent according to the data in 2019.[178] The solution for this problem can be for the US regulators to extend this rule to all NRSROs regardless of group affiliation.

In terms of conflicts of interest arising from shareholder control, Mattarocci identified two major risks: for smaller CRAs the owner of the credit rating company can also take the managerial role; for bigger CRAs the owners of the credit rating company are usually banks, investment companies or other credit rating companies which established commercial agreement.[179] For the former, the lack of separation between management and the ownership can lead to a low quality of service. The EU law prohibits the rating CRA and the analysts who are directly involved in the issuing of a credit rating to have a direct or indirect ownership interest in the rated entity and the rated securities or to engage in transactions in any financial instrument issued by the rated entities.[180] It prohibits a member of the administrative or supervisory board of the rated entities being directly involved in the issuing or approving of the credit ratings.[181] It imposed a strict prohibition on a CRA or persons who are directly involved in the issuing or approving of credit ratings from directly or indirectly owning financial instruments of the rated entity.[182]

In terms of ownership of the rated entity and the rated securities, the US law has a similar approach like the EU law, ie, NRSROs or their key analysts, which participated in determining or approving a rating are prohibited from owning securities or having any direct ownership interest in the entities rated by the same NRSROs.[183] NRSROs are prohibited from continuously rating companies which contributed more than 10 per cent of their net revenues.[184] This strict prohibition is welcome as it prevents the NRSROs and analysts inflating ratings because of their personal interests in the production of the securities. The US law has provisions to separate the management and marketing team from the rating analyst and methodology development teams.[185] This separation should improve the objective of the analysts without being influenced by the commercial consideration of the rating business. Nonetheless, in comparison, the US law did little to address the conflicts of

177 Mattarocci (n 30) 90.
178 SEC (n 11) 11.
179 Mattarocci (n 30) 89.
180 Regulation (EU) No 1060/2009, Annex I(B)(1), (B)(3)(a), (B)(3)(d) & (C)(1).
181 Regulation (EU) No 1060/2009, Annex I(B)(3)(c).
182 Regulation (EU) No 1060/2009, Annex I (B)(3)(a).
183 17 CFR s 240.17g-5(c)(2).
184 17 CFR s 240.17g-5(c)(1).
185 17 CFR s 240.17g-5(c)(8).

interest arising from shareholder control. To improve, it should consider adopting the shareholding limitation rules, ie, the 10 per cent and the 5 per cent shareholding limitation rules, and extend the application of the 5 per cent shareholding limitation rule to all NRSROs regardless of group affiliation.

Mandatory contract rotation rule

Article 6b CRA Regulation No 462/2013 limits the contractual relationship between a CRA and the issuer to a maximum of 4 years for issuing ratings on re-securitizations.[186] 'Re-securitization' is a securitization where at least one of the underlying exposures is a securitization position.[187] This provision only applied to re-securitizations which have underlying collaterals of securities or structured products, such as RMBS, CMBS, ABS, CMOs, CDOs and CDS.[188] This rotation requirement is designed to reduce the stickiness deriving from the commercial contractual relationship, which is a major cause for conflicts of interest and rating shopping.

The mandatory contract rotation rule offers a valuable alternative solution to the hotly debated abolition of the 'issuer-pay' model. According to Boylan, the rotation rule can preempt the need of a new intermediator under the Franken Amendment/Random Selection Model in charge of assigning deals to CRAs.[189] It deals with the conflicts of interest raised from a long and cosy relationship between the rater and the issuers. A mandatory rotation should reduce the incentives for CRAs to issue inflated ratings in order to maintain a long contractual relationship with the issuer, who is also the fee payer under the 'issuer-pay' model.[190] Hence, the adaptation of an alternative business model to the current 'issuer-pay' business model would be unnecessary. Moreover, US regulators require CRAs to implement policies designed to limit the interaction of the management and marketing teams from analysis activities.[191] CRA Regulation No 1060/2009 had already required the separation of credit rating activities from all political and economic influences.[192] Hence the EU law went a step further to implement the rotation rule compared to the US approach. This rule converges with the mandatory audit partner rotation under the Sarbanes–Oxley Act of 2002.[193] It contributed to improving competition and bringing diversity as it allows more CRAs to participate and to form new contracts.[194] It should increase the chance for small CRAs to be selected to rate SFPs because this rule does not apply to small CRAs with less than 10 per cent of market shares.[195] As it stands, this rotation rule should apply to the 'Big

186 Regulation (EU) No 462/2013, art 6b(6).
187 Regulation (EU) No 2017/2402, art 2(4).
188 EC (n 155) 86.
189 Boylan (n 69) 40.
190 Regulation (EU) No 462/2013, recital 12.
191 Ibid 42; 17 CFR 240.17g-5(c)(8).
192 Regulation (EU) No 1060/2009, Annex I(A)(1a) & art 7(2).
193 Sarbanes–Oxley Act of 2002, 15 USC 7201 s 203, amending 15 USC 78j–1.
194 Harry Edwards, 'CRA Regulation III and the Liability of Rating Agencies: Inconsistent Message from the Regulation on Credit Rating Agencies in Europe' (2013) Law and Financial Markets Review, doi: 10.5235/17521440.7.4, 190.
195 Regulation (EU) No 462/2013, art 6b(2).

Three' who are the only CRAs in the EU holding more than 10 per cent of market shares. The EU gauged the scope of mandatory contract rotation rule at the right level in excluding the smaller CRAs so as to reduce the financial and operational burden when entering a new contract or assessing the credit risks of a new SFP.

In contrast, this rotation rule was criticized for imposing negative effects on the quality of ratings to the point of discouraging proper competition as the choice of a CRA would not be based on expertise but rather be dictated by availability.[196] The wait-for-its-turn argument is not entirely waterproof since the competition among the influential CRAs is still fierce even though only a few CRAs can rate re-securitizations.[197] This rule is expected to improve the diversity of the rating agencies because it can reduce the 'lock-in' effect and allow more CRAs to evaluate the credit risks of certain SFPs with different perspectives. Moreover, a 4-year contractual period should allow sufficient time for the newcomers to provide more accurate and dimensional credit risk assessment for the financial products.

Apart from the function of reducing conflicts of interest, this rule should promote the competitiveness of the smaller CRAs because it allows more smaller CRAs to enter into new contracts with issuers, hence, to reduce the dominant market shares of the 'Big Three' and to bring positive effects on the credit rating market.[198] Therefore, this rule should provide more benefits than the Franken Amendment/Random Selection Model. Some argued that the risks associated with this measure outweigh the potential benefits because it 'lead[s] to uncertainty about the stability of ratings on a periodic basis'.[199] The uncertainty of the stability of ratings should be very limited because this provision only applies to re-securitizations initially before gradually extending to other SFPs. In terms of the cost to issuers, this mandatory contract rotation rule did not generate a huge negative impact for issuers, CRAs and the market due to the limited issuances of re-securitizations in recent years.[200]

Nonetheless, the global re-securitization market failed to revive following the Financial Crisis.[201] While this provision appeared to be a powerful enactment for dealing with conflicts of interest and lack of competition, its impact is nevertheless extremely limited as only a fraction of re-securitizations were issued after the financial crash. The EU Commission's report showed that CRAs had been unable to issue ratings for re-securitizations since 2010 because the re-securitization market failed to revive in the EU following the Crisis; there was a limited interest in issuing re-securitization products.[202] Moreover, Article 8(1) of Regulation 2017/2402 issued a ban on re-securitizations, ie, prohibiting securitization positions to be used as an underlying exposure in a securitization.[203] This ban

196 EC, 'Study on the Feasibility of Alternatives to Credit Ratings, Final Report' (2015) EV-04-15-587 EN, 81 and 88.

197 Regulation (EU) No 462/2013, Recital 14.

198 Regulation (EU) No 462/2013, Recitals 12 and 14.

199 Edwards (n 194) 190.

200 EC (n 155) 9.

201 Ibid 86; BIS, 'International Banking and Financial Market Developments' (September 2019) BIS Quarterly Review, 11, 3.

202 EC (n 155) [Footnote 113], 86.

203 Regulation (EU) No 2017/2402, art 8(1).

represents a general reproach by regulators towards the issuance of re-securitizations after the Financial Crisis.

Hence, in order for the rotation rule to have real bite it should extend to covered bonds[204] and other securitized and/or structured products in general, including RMBS, CMBS, ABS, CMOs, CDOs and CDS, because these products are more complex and riskier than corporate bonds. Corporate bonds and sovereign bonds ratings had generally performed well in the past under the well-developed methodologies.[205] In contrast, CRAs were heavily criticized for their inflated ratings for the SFPs, particularly for the abrupt but untimely downgrading on ABSs, RMBSs and CDOs. Ninety-eight per cent of 'Fallen Angles' happened in ABSs, RMBSs and CDOs,[206] ie, the tranches of these SFPs suffered downgrade(s) by eight or more notches from their original ratings at once.[207] CRA Regulation No 462/2013 requires the EU Commission to review the feasibility of the mandatory contract rotation rule to cover other classes[208] although, to date, the Commission did not broaden its scope of Article 6b CRA Regulation No 462/2013. While the mandatory contract rotation rule is a step in the right direction for reducing conflicts of interest and improving competition, regulators should further extend Article 6b CRA Regulation No 462/2013 to other securities' products for this provision to bring real impacts in reducing conflicts of interest and promoting competition. It is noted that any extension of the rotation rule to other market segments is likely to add extra financial burdens and implementation difficulties to the CRAs and the issuers.[209] The additional rotation rule to cover other asset classes requires more time and resources of new CRAs, resulting in more costs for issuers as well as extra financial burdens in the financial market. Hence, any extension should be imposed on other asset classes in an orderly manner, taking into consideration their complexity to avoid volatility and higher costs in the debt markets, such as allowing the maximum length of contract to be 4 years. This rotation rule should not apply to smaller CRAs.

Mandatory double rating rule

Along with the mandatory contract rotation rule, CRA Regulation No 462/2013 imposes mandatory double rating requirements for all types of SFPs, which include re-securitizations, ie, the issuers must engage at least two independent CRAs for assigning ratings for the same SFPs.[210] The issuers should consider appointing one small CRA with less than 10 per cent of market shares[211] although the appointment of a small CRA is not mandatory.

204 EC, 'Study on the State of the Credit Rating Market Final Report—Executive Summary' (January 2016) MARKT/2014/257/F4/ST/OP, 7.

205 Lawrence White, 'Credit-Rating Agencies and the Financial Crisis: Less Regulation of CRAs is a Better Response' (2010) Working papers 10-03, New York University, Leonard N. Stern School of Business, Department of Economics, 16.

206 Benmelech and Dlugosz (n 42) 181.

207 Ibid 179.

208 CRA Regulation No 462/2013, Recital 13.

209 EC (n 155) 10.

210 Regulation (EU) No 462/2013, art 8c.

211 Ibid art 8d.

This provision aims to improve the quality of ratings and to minimize dependence.[212] Double ratings should force CRAs to assign ratings with due care since any wrong ratings assigned recklessly or under the influence of conflicts of interest would be compared to the second rating.

The implementation of this provision should not overburden the credit rating industry as well as the issuers. The appointment of two or more CRAs has long been standard practice for the mainstream public securitizations and other deals seeking Bank of England and European Central Bank eligibility.[213] Under the US law, the 'two-rating norm', mainly relying on the credit ratings of Moody's and S&P, is also a well-established practice in the securities market.[214] The US law has no explicit requirement of mandatory double ratings, although previously a low percentage of haircut was applied if the securities received high ratings by at least two NRSROs under the Net Capital Rule, Rule 15c3-1.[215] Issuers would have more to gain than to lose in the form of advantageous financing rates on their issuances by following the 'two-rating norm' from major agencies.[216] Empirical studies showed that 75 per cent of raters have a customer portfolio served by more than 10 other CRAs in 2012, whilst the non-multi-rated customers are 0 per cent.[217] On the other hand, the extra cost should be the minimum because it can only affect limited securitizations which did not obtain two ratings.

In addition, under the current formula of the mandatory double rating rule, issuers have no legal obligation to appoint a small CRA,[218] but merely documenting the decision if after some consideration they did not appoint a small CRA. Under the 'issue-pay' business model, issuers select CRAs according to their reputation capital, which is largely based on the CRA's market shares. The issuers are likely to choose the 'Big Three' with more robust reputation capital.[219] Nonetheless, Mattarocci showed that the well-established multi-rating phenomenon is unrelated to the CRA's size and relevance.[220] Depending on whether issuers will choose smaller CRAs for the second rating, two rating CRAs should maintain a high level of independence and avoid collusion in their ratings for this double rating rule to have a real effect. In the case of a smaller CRA being selected, regulators or any securities market supervisory bodies should be mindful that the smaller CRA does not inflate ratings in order to compete for market shares.[221] Mahlmann's study showed that smaller CRAs, in

212 Mollers (n 158) 341.

213 Regulation (EU) No 462/2013, Recital 11; Clifford Chance, 'New Disclosure and Dual Rating Requirements in European Structured Finance' (2013) Briefing note <https://www.cliffordchance.com/briefings/2013/05/new_disclosure_anddualratingrequirementsi.html> accessed 21 March 2019, 4.

214 Thomas Mahlmann, 'Do Bond Issuers Shop for a Better Credit Rating?' (2006) <https://www.bis.org/bcbs/events/rtf06maehlmann.pdf> accessed 21 May 2022, 2.

215 SEC, 'Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934' (2013) 17 CFR Parts 240 and 249, Release No. 34-71194; File No S7-15-11, 7.

216 Mahlmann (n 214) 5.

217 Mattarocci (n 30) 43 and Table 3.8.

218 ESMA, 'Report on CRA Market Share Calculation' (2018) ESMA33-9-281, 6.

219 EC (n 155) 25.

220 Mattarocci (n 30) 46.

221 EC (n 155) 62.

this case Fitch, strategically lowered the rating standards and issued higher ratings compared to the two main CRAs, Moody's and S&P.[222] Hence, the mandatory double ratings rule must be backed up with the mandatory contract rotation rule by which issuers must choose a different CRA to rate the SFPs at least every 4 years so as to reduce the need for rating inflation for market shares grabbing.

In short, the EU law provided a more sophisticated system, compared to the US law, to reduce conflicts of interest and to improve the CRAs' independence and integrity. It implemented provisions such as the organizational and operational requirements for CRAs, the analyst-rotation rule, the shareholding limitation rules, the mandatory contract rotation rule and the double-rating rule. Some provisions rely heavily on the CRAs' self-management and internal-control systems. The EU's multifaceted approach should work to effectively deal with the conflicts of interest issue without having to replace the 'issuer-pay' business model. The remaining improvement for regulators should be to broaden the coverage of 5 per cent shareholding limitation rule and the mandatory contract rotation rule to substantiate their impact.

6. Conclusion: a balanced cure for the disease

The regulatory reforms in the USA and the EU to correct the conflicts of interest of CRAs demonstrates a dilemma in dealing with the 'disease' while avoiding the adoption of a harsh cure, which can have a pervasive effect on the rating industry. The dominant 'issuer-pay' business model was a major cause of conflicts of interest, although it improved the informational advantage and profitability of the industry. The EU law is more effective in reducing the conflicts of interest and focuses on dealing with the 'disease' and a balanced cure. It should be an important model for regulators because it does not drastically change the 'issuer-pay' model. It imposed the shareholding limitation rules and the mandatory analyst-rotation rule to eliminate the commercial influence on credit ratings and the rating process. It imposed a mandatory contract rotation rule and the double-rating rule, which should reduce the cosy relationship between CRAs and issuers and eliminate the potential for rating shopping. The mandatory contract rotation rule should be a more robust solution compared to the Franken Amendment/Random Selection Model in reducing conflicts of interest and improving competition and the diversity of the rating industry. Hence, it should be widely applied to other structured products in addition to re-securitizations.

The US legal reforms are partially successful although gaps still exist because the SEC did not fully carry out the US Congress's intentions, such as failing to improve the 'issuer-pay' model. The Dodd–Frank Act reduced the CRAs' conflicts of interest by implementing the look-back policy and a prohibition on the management and marketing boards influencing rating analyses and rating methodologies' development. While both provisions are effective rules to reduce conflicts of interest, the SEC should continue to enhance the

222 Mahlmann (n 214) 4.

compliance of NRSROs. The most important provision under the US law should be to adopt an alternative remuneration model and to replace the 'issuer-pay' model, although the SEC failed to give effect to the US Congress's initiative. Hence the conflicts of interest and rating inflation can still widely exist in practice under the US law, which has a significant impact on the credit rating industry because the most influential CRAs are subject to the US regulation.

The solution for this problem can be two-fold: to adopt the modified Franken Amendment/Random Selection Model or to adopt the EU-like multifaceted approach without overhauling the existing remuneration system. The former is still a viable alternative to the 'issuer-pay' model as it deals with the root cause of the 'disease' as well as preserving the essence of the 'issuer-pay' model. Hence it has a less drastic impact on the industry as it does not uproot the 'issuer-pay' business model. For an optimum outcome, regulators should consider adopting three improvements for this proposed model, such as using an independent selection committee, imposing additional disclosure requirements for justifications if CRAs use a rating model, which departs from the published or ratified quantitative models and lastly, to adopt the mandatory double rating rule. Among these suggested improvements, this article proposes that the current OCR is rightfully equipped to develop the selection criteria and to carry out the selection function along with other administrative roles. The mandatory double rating rule should be a key improvement for the US law in dealing with the conflicts of interest without additional burdens being posed on CRAs due to the well-established 'two-rating norm'.

On the point of the multifaceted approach under the EU law, the US regulators should consider adopting the shareholding limitation rules, the mandatory contract rotation rule and the double rating rule. First, the US law should impose additional rules to deal with the conflicts of interest and reduce the collusion of NRSROs caused by the shareholder's influence. To improve, it should consider adopting the shareholding limitation rules, ie, the 10 per cent and the 5 per cent shareholding limitation rules and to extend the application of the 5 per cent shareholding limitation rule to all NRSROs regardless of group affiliation. Secondly, the mandatory contract rotation rule should offer a feasible alternative solution to the conflicts of interest caused by the 'issuer-pay' model, hence rendering a clearinghouse unnecessary. At the same time, it should improve the competitiveness of smaller CRAs and bring diversity and positive effects to the rating industry. For this rule to have a substantive impact, the mandatory contract rotation rule should be extended to cover other classes of assets, such as the covered bonds and other securitized and structured products, which were highly inflated and suffered heavy losses during the last Financial Crisis. To prevent volatility and higher costs in the debt markets, any extension should be imposed in an orderly manner and should not apply to smaller CRAs. Thirdly, the mandatory double rating rule should be a valuable provision to improve the quality of credit ratings and minimize the dependence of CRAs. Giving the well-established 'two-rating norm', this rule should not generate an overburdensome cost and implementation difficulties to the rating industry as well as to the rated companies. In the case of when a smaller CRA is chosen, regulators should be mindful that the smaller CRAs do not inflate ratings for market share grabbing. Therefore, the mandatory double rating rule should be backed up with the mandatory contract rotation rule to eliminate the commercial consideration of CRAs when assigning ratings.

The SEC has had no intention of adopting the Franken Amendment/Random Selection Model since 2012 despite the fact that the other existing provisions are relatively weak. Hence, the problem of conflicts of interest and rating inflation continue to impose a huge challenge to the rating industry and to the proper functioning of the financial market. This problem can be exacerbated when the credit rating industry gains more economic importance following the last Financial Crisis, particularly when the US CRAs play a dominant role in the international rating market. This article recommends that the SEC should solicit public comments with a view to adopting additional rules to deal with the conflict of interests issues, rather than pushing the SEC to adapt the alternative model, while no intention on this approach was shown. The shareholding limitation rules, the mandatory contract rotation rule and the mandatory double rating rule together with additional improvements should be both valuable and feasible. Hence, they should be a focus for regulators to eliminate conflicts of interest as well as to deal with other issues, such as to improve competition, industrial diversity and the rating quality of CRAs.