Regulation and Responsibility of the Credit Rating Agencies vis-à-vis the Current Economic Crisis: A Comparitive Analysis

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Abstract

This essay attempts to provide an overview of the regulatory frameworks governing credit rating agencies in the United States, European Union and India against the background of the role played by the credit rating agencies in the current worldwide economic crisis. The credit rating agencies (CRAs) have been blamed for their contributory role in the on-going international financial crisis - primarily since the ratings for asset-backed securities were excessively generous. The essay studies in detail the regulatory initiatives undertaken by the Securities and Exchange Commission, and their shortcomings. An effort has made to analyze the regulatory framework in India, especially the SEBI Regulations, and the lacunae therein. The essay concludes by suggesting possible solutions to better regulate the credit rating mechanism and ensure transparency.

I. Introduction

"There are two superpowers in the world ... the United States and Moody's Bond Rating Service ... and believe me, it is not clear sometimes who is more powerful."

- Senator Joseph Liberman, Testimony before the Senate Committee on Governmental Affairs, 107th Cong. 471 (March 20, 2002).

Credit rating agencies play an important role in financial and capital markets. Their primary function is to assess the credit worthiness of a company and its' debt obligations. These ratings greatly influence the ability of the issuers of securities to raise capital by lowering their costs,[1] and also influence the decisions of some fiduciaries to invest. In some cases opinions of these agencies are important in structuring transactions which involve financial products like credit derivatives and asset-backed securities.[2] Further, the advanced use of credit ratings in individual

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1 McDonald Wakeman, *The Real Function of Bond Rating Agencies* in The Modern Theory of Corporate Finance 410-415 (Clifford W. Smith Jr. ed 1990); Amy Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well Placed Reliance or Free Market Interference?*, 20 Seton Hall Legis J. 293, 294 (1996); *See also*, Francis Bottini Jr. *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*, 30 San Diego L. Rev. 579 (1993).

2 Rhodes, *Ibid.* at 345-351; Steven Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan J. L. Bus. & Fin. 133 (1994). *See also*, David Reiss, *Subprime Standardization. How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 Fla. Stat U. L. Rev. 985 (2006).

contracts has increased their importance. The use of these "*ratings triggers*"[3] definitely raises the stakes in the rating business.

The recent economic crisis has put the spotlight on the credit agencies as never before. Many observers believe that novel financial products received undeserved high credit ratings, which served to aggravate the turmoil. This is primarily because the high credit ratings on such instruments helped induce the investors to purchase them. When these instruments started to appear riskier than their traditional counterparts, these investors lost confidence in the products, causing markets for such products to seize up, and thus resulting in severe economic consequences for the global financial system.[4]

Whether this view is accurate or not, it definitely highlights the importance of credit rating quality and calls into question the incentives for the agencies to produce high quality ratings. However, the picture of the ratings dilemma would be inaccurate if it were only to highlight shortcomings on the part of the Credit Rating Agencies (CRAs). Section I of the essay lays down a brief background by giving an overview of the current economic crisis in light of the security ratings. Section II explores the relationship between credit ratings and structured finance. The regulatory initiatives by the SEC, both prior and subsequent to the subprime crisis have been analyzed in depth in Section III- special attention is paid to the Credit Rating Reform Act 2006. It has been argued that the Credit Rating Reform Act 2006 neither devised nor enhanced remedies to provide direct relief for inferior quality ratings. It focused merely on steps to improve the agencies' incentives and to adjust an investor's dependence on the ratings. While Section IV of the essay analyzes in detail the regulatory framework for credit rating agencies in the European Union, Section V attempts the same in an Indian context. Section VI of the essay explores possible solutions and alternatives to the problem.

II. The Worldwide Credit Crisis and the Credit Ratings

The current economic crisis is an interrelated series of events which still continue to unfold. To name just a few of its aspects, the Wall Street giants have fallen, the stock markets worldwide have crashed, the credit markets have seized up-threatening economic activity outside stock exchanges and the governments worldwide have had to devise bailout packages.

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3 The phrase is borrowed from Arthur Pinto. *See*, Arthur Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 Am J Comp L 341 (2006)

4 Securities and Exchange Commission, *Annual Report on Nationally Recognized Statistical Rating Organizations as Required by the Credit Rating Agency Reform Act of 2006*, 35 (June 2008), available at http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf [hereinafter *SEC NRSRO Report*].

The causes of this economic crisis are diverse, and widely interrelated.[5] However, the observers have almost uniformly criticized the rating agencies for their role in exacerbating the crisis. These include the official bodies which have reported on the crisis-the Securities and Exchange Commission,[6] the Financial Stability Forum,[7] the International Organization of Securities Commissions[8] and the President's Working Group on Financial Markets.[9]

The common thread in these and other such reports is that rating agencies did a poor job of assessing the default risk of the CDOs and other such instruments based on subprime mortgage backed securities.[10] Further, high ratings on such instruments had a disproportionate effect on financial markets, and when a large number of subprime borrowers started defaulting on their mortgages, the low quality of the ratings was finally revealed- which led to severe consequences.[11] In particular, investors were forced to sell the securities at very low prices to maintain liquidity.[12]

While the observers have highlighted the default rates on the underlying subprime mortgages, it is not the sole problem. Rating agencies have also been criticized for fundamental defects in their methodologies to rate such products.[13] In fact, ratings on some products which were not even directly linked to the subprime mortgages appear to have performed poorly. For example, CPDO (Constant Proportion Debt Obligation) was introduced in 2006, as an instrument designed to meet fixed yield targets by adjusting leverage according to market conditions.[14] The basic source of risk and return in a CPDO is a ratio of corporate credit expanse.

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5 Jennifer Bethel (et al.), *Legal and Economic Issues in Litigation Arising from the 2007-2008 Credit Crisis*, Harvard Law School Program on Risk Regulation Research Paper No. 08-5, 15-16 (November 17, 2008) available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1096582.

6 Securities and Exchange Commission, *Summary Reports of Issues Identified in the Commission Staff's Examination of Select Rating Agencies*, 2 (July 8, 2008), available at http://www.sec.gov/news/studies/2008/craexamination070808.pdf [hereinafter *SEC Staff Examination Report*]

7 Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, 32 (April 7, 2008), available at http://www.fsforum.org/publications/r_0804.pdf [hereinafter *FSF Report*].

8 Technical Committee of the International Organization of Securities Commissions, *The Role of Credit Rating Agencies in Structured Finance Markets*, 2 (May, 2008), available at http://www.cmvm.pt/NR/rdonlyres/85312A11-A927-4F63-810A-082C1A2CF5F8/9759/RelIOSCOsobrePapelCRAMercProdEstrut.pdf [hereinafter *IOSCO CRA Report*].

9 The President's Working Group on Financial Markets, *Policy Statement on Financial Market Developments*, 2 (March, 2008), available at http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf. [hereinafter *PWG Group Policy Statement*].The members of the Working Group include the Chairman of the Federal Reserve Board of Governors, the Secretary of US Treasury and the Chairman of the Securities and Exchange Commission.

10 *FSF Report*, Supra n. 7 at 33; *IOSCO CRA Report*, Supra n. 8 at 2.

11 Fabian Dittrich, The Credit Rating Industry: Competition and Regulation 17-18 (2007).

12 Jennifer Bethel (et al.), *Supra* n. 5 at 22.

13 Timothy Sinclair, The New Masters of Capital: The American Bond Rating Agencies and the Politics of Creditworthiness 36-39 (2005).

14 Paul Davies and Sarah O' Connor, *Default Protection puts CPDOs at Risk*, Fin. Times, (Feb 19, 2008).

Thus it has no direct connection to the subprime mortgages. Yet, Moody's downgraded 21 European CPDOs in early 2008- about half the total number it had rated.[15] However, even at conservative estimates, some of the CPDO downgrades reflected a coding error in Moody's part. In fact, in early 2008 Moody's reportedly discovered that it had erroneously rated several billion dollars worth of CPDOs at AAA level as a direct result of a coding error which affected data integrity.[16] It is very probable that the problems with agency models were augmented by rating-driven herding behaviour among CDO arrangers. Once an arranger devised a structure that received the desired ratings, the other arranges may have followed- which caused the deficiencies in the rating agency methodology to spread.[17]

Thus, if the agency models were deficient in totality, as suggested by the critics, then the agencies not only failed in anticipating the performance of subprime loans and the payback ability of the subprime borrowers, but also failed at a fundamental level as they *did not know* what they were doing, at least with respect to some (if not all) novel securities. This aspect requires a detailed enquiry and analysis.

III. Ratings and Structured Finance

The advent of securitization has perhaps been the most important development in finance in the recent past.[18] Securitization refers to the issuance of securities using a pool of assets as collateral. The process of securitization typically involves the collection or pooling of loans and the sale of securities backed by those loans.[19] It provides various benefits, and presents far-ranging implications for any financial system. Such contracts are arranged in a manner that the investors have no remedy against the party which sold the claims to the securitization company,[20] and creditors of the selling party ordinarily have no capacity to pursue the assets sold to the investment company.[21] A critical feature of securitization is allocating the cash flows generated by such securities to pool of different classes or 'tranches' with differing probability of default and deferential protection against losses.[22]

15 Aaron Lucchetti and Kara Scannell, *New Debt Products Test Moody's Methods*, Wall St J. C12 (May 22, 2008).

16 *SEC NRSRO Report*, *Supra* n. 4 at 34.

17 Jennifer Bethel (et al.), *Supra* n. 5 at 26-27.

18 Arvind Rajan (et al.), The Structured Credit Handbook 3 (2007), Kenneth Kettering, *Securitization and its Discontents. The Dynamics of Financial Product Development*, 29 Cardozo L. Rev. 1553, 1555 (2008).

19 Frank Fabozzi and Franco Modigliani, Capital Markets: Institutions and Instruments 441 (2005).

20 Steven Schwarcz (et al.), Structured Finance: A Guide to The Principles of Asset Securitization 7 (2004); Kettering, *Supra* n. 18 at 1565.

21 Schwarcz, *Ibid.* at 69; Kettering, Ibid. at 1565-1566 *See also*, Lois Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 Tex L. Rev. 595, 597 (1998).

22 Lakhbir Hyre, *Concise Guide to Mortgage Backed Securities* in Salomon Smith Barney Guide to Mortgage-backed and Asset-backed Securities 51-52 (Lakhbir Hyre ed. 2002).

Securitized products have lately become more complicated. Structured finance products which are particularly relevant to this essay include the sub-prime mortgage backed securities (MBS) and the collateralized debt obligations (CDOs). Mortgage backed securities are securitized products with residential home mortgages which serve as underlying assets. While tranched MBS themselves are not really innovative, having been developed in the late 80s, the sub-prime MBS securitization did not become marked until this decade.[23] MBS backed CDOs are structured products where MBS are the underlying assets.[24] Most often the MBS are registered under the Securities Act, 1933[25] while the CDOs generally are not.[26] Since CDOs are sold through Rule 144 A[27] offerings, the offerees must be qualified institutional investors like hedge funds, pension funds and investment banks.[28]

While agency ratings have been vital for investor acceptance of the said new instruments, the reasons for the same are debatable. The ratings may be needed to satisfy the regulators. On the other hand, it may also be imperative because of the novelty and complexity of the product in question- which places premium on credit risk assessments from trusted intermediaries.

IV. Regulatory Initiatives regarding Credit Agencies in USA: The Credit Agency Reform Act, 2006

The worldwide economic crisis coupled with the apparent defects in the agency rating models on structured products has spurred a flurry of regulatory and legislative activity.

There exists a school of thought which believes that the function of a rating agency is to make a high quality assessment of the issuer's creditworthiness available to other investors. This in turn may arise from the fact that the agency may possibly have access to private information.[29] The value of a rating agency's business thus

23 Ibid. at 45. *See also*, Adam Ashcraft and Til Scheuermann, *Understanding the Securitization of Subprime Mortgage Credit*, Fed. Res. Bank of N.Y. Staff Report No. 318, 2 (March 11, 2008), available at SSRN: http://ssrn.com/abstract=1071189

24 Joseph Mason and Josh Rosner, *Where did the Risk Go? How Misapplied Bond Ratings cause Mortgage-backed Securities and Collateralized Debt Obligations Market Disruptions*, 62 (March 3, 2007), Working Paper series, available at SSRN: http://ssrn.com/abstract=1027475

25 Jennifer Bethel (et al.), *Supra* n. 5.

26 *Ibid*

27 Rule 144A, adopted pursuant to the U.S Securities Act of 1933, provides a safe harbor from the registration requirements of the Securities Act, 1933 for certain private re-sales of restricted securities to qualified institutional buyers (QIBs). When a broker or dealer is selling securities in reliance on Rule 144A, it is subject to the condition that it may not make offers to persons other than those it reasonably believes to be QIBs. *See infra* n. 28.

28 Securities and Exchange Commission, 17 C.F.R. § 230.144A-7(d)(1), (4-1-07 edition), available at http://edocket.access.gpo.gov/cfr_2007/aprqtr/pdf/17cfr230.144A.pdf.

29 *IOSCO CRA Report*, *Supra* n. 8 at 3; Mason and Rosner, *Supra* n. 24 at 18.

derives from its reputation of issuing a high quality rating.[30]

Advocates of this model believe that market discipline in form of loss of reputation provides the credit rating agencies with the right incentives for high quality ratings,[31] and therefore disregard liability or other *ex post* legal remedies through private litigation- such as compensation and damages- as an apt adjunct to the reputational mechanism.[32]

Several aspects of the rating market mechanisms have however been identified, which caused it to perform below par leading up to the economic crisis. These include lack of competition, absence of transparency and conflict of interests. These deviations are critically important and severely affect the functioning of the agencies,[33] and an attempt shall be made subsequently in the essay to study each deviation in detail.

These deviations, either separately or in conjunction could cause the credit rating mechanism to perform poorly, and the regulators have been discussing strategies to address such deviations since the corporate scandals of 2002.[34] It is therefore ironical that the economic crisis broke out just as the Congress and the SEC had finished work on a regulatory mechanism to address the issues raised by the corporate scandals of 2001-02. The Sarbanes-Oxley Act, 2002 required the SEC to hold hearings on rating agency performances,[35] and the Commission published a report in 2003 raising several questions about this subject.[36] After many sets of hearings, the Congress enacted the Credit Agency Reform Act in 2006.[37] While this Act gave the SEC express regulatory authority over rating agencies in several aspects, it also sharply curtailed its jurisdiction. As an example, the Credit Agency Reform Act substantively denies both the SEC and the states the authority to "regulate the substance of credit ratings or the procedure and methodologies by which any NRSRO

30 *See* Gregory Husisian, *What Standards Should Apply to the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 Cornell L. Rev. 411, 422 (1990); Stephen Choi, *Market Lessons for Gatekeepers*, 92 Nw. U. L. Rev. 916, 961 (1998); Steven Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, U. Ill. L. Rev. 1, 26 (2002)

31 Husisian, *Ibid.* at 426-27; Choi, *Ibid.* at 918.

32 Claire Hill, *Regulating the Rating Agencies*, 82 Wash. U. L. Q. 43, 45 (2004); Husisian, *Id.* at 444; Choi, *Id.* at 918-19; Jacob Fisch, *Rating the Raters. Reflections on Proposals for Regulatory Reform of the Rating Agencies*, 5 U.C. Davis Bus. L. J. 3 (2004).

33 Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Rating Agencies*, 77 Wash. U. L. Q. 619 (1999).

34 *Ibid.*

35 S. 702, Sarbanes Oxley Act 2002, 116 Stat. 745.

36 Securities and Exchange Commission, *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market as required by Section 702(b) of the Sarbanes-Oxley Act of 2002*, (January 2003), available at http://www.sec.gov/news/studies/creditratingreport0103.pdf [hereinafter *SEC SOX Report*].

37 Credit Rating Agency Reform Act 2006, 120 Stat. 1327, codified at 15 U.S.C. § 78o-7. (hereinafter referred to as CRRA Act, 2006).

determines credit ratings."[38] Similarly, the Act also requires that all SEC rules adopted "pursuant to this title, as they apply" to NRSROs be "narrowly tailored to meet the requirements of this title applicable to" NRSROs,[39] and "creates no private right of action."[40] However, the Act does contain a saving provision recognizing the authority of the SEC to bring actions for "fraud or deceit" against the rating agencies and their employees.[41] In June 2007, the SEC adopted the rules under the 2006 Act.[42] The Credit Rating Reform Act 2006 and the rules represent the culmination of the 'post-Enron' regulatory effort to rein in credit rating agencies.

Apart from provisions relating to rating mechanisms, the CRRA 2006 also addressed two sets of issues not directly linked with rating performance: insider trading and tying like practices. Insider trading is a potential issue as the rating agencies may use non-public sensitive information in making their determinations,[43] and enjoy an exemption from Regulation FD, which prohibits the selective dissemination of material nonpublic information.[44] The 2006 Act directs NRSROs to adopt schemes and measures to prevent the misuse of material, nonpublic information.[45] The 2006 Act further directs the SEC to prohibit particular rating practices if it determines them to be coercive,[46] and calls the SEC's attention to tying like practices, such as 'notching'.[47] 'Notching' refers to the practice of lowering ratings on or refusing to rate securities issued by certain asset pools (for example CDOs) unless a substantial portion of the assets within those pools were also rated by the same NRSRO.[48] After a contentious debate, however, the SEC ultimately decided to allow notching if there was no 'anticompetitive purpose'.[49]

The economic crisis called for further regulatory scrutiny of rating agencies from several quarters. State Attorney Generals in New York, Ohio and Connecticut started investigations,[50] with the New York Attorney General announcing a settlement

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38 15 U.S.C. §78o-7(c) (2).

39 *Ibid.*

40 15 U.S.C. § 78o-7(m) (2).

41 15 U.S.C. § 78o-7(o) (2).

42 Securities and Exchange Commission, *Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Final Rule*, 72 Fed. Reg. 33,564, (June 18, 2007), available at http://www.sec.gov/rules/final/2007/34-55857.pdf [hereinafter *SEC 2007 Rule*].

43 *SEC 2007 Rule, Ibid.* at 33, 586

44 *See* 17 C.F.R. § 243.100(a), (b)(2)(iii), available at http://cfr.vlex.com/vid/19643687#

45 15 U.S.C. § 78o-7(g).

46 15 U.S.C. § 78o-7(t).

47 *SEC 2007 Rule. Supra* n. 42 at 33, 623.

48 *SEC SOX Report, Supra* n. 36 at 24.

49 *SEC 2007 Rule, Supra* n. 42.

50 *See AAAsking for Trouble*, The Economist (July 12, 2007).

with the major rating agencies in June 2008.[51] This agreement was designed to improve transparency in the mortgage-backed securities industry. Under the new agreement, the credit ratings agencies were required to alter their fee structure and required investment banking due diligence reports before they were permitted to issue ratings.[52] On its part, the SEC conducted a staff examination of the agencies.[53] It proposed additional rules to govern structured financial products which would deny regulatory recognition to ratings on innovative products unless the products had received prior SEC approval.[54] The President's Working Group on Financial Markets described "flaws in credit rating agencies' assessments" of certain structured products as the "principal underlying cause" of the global meltdown.[55] Similar recommendations were made by the Financial Stability Forum[56] and the International Organization of Securities Commissions.[57]

It may be said, therefore, that the fundamental objective of the policy reform was the same during the economic crisis as it was before it. The efforts of the regulators continued to aim at promoting competition and increasing transparency, and reducing conflicts of interest. The SEC did not formulate any corrective against the inferior quality ratings. They focused instead on measures to improve rating agencies' incentives and to adjust an investor's reliance on the agency ratings.[58]

Thus, studying these diverse issues and the regulatory steps taken to tackle them is a convenient mode to review the shortcomings of both the credit rating mechanism and the regulatory initiatives in this regard.

1. Limited Competition: Currently, the rating agency market is dominated by the three big players - S&P, Moody's and Fitch. The market concentration of these agencies is reported to be in the range of 85-95%.[59] While a high degree of market concentration does not in itself determine its anti-competitiveness, such a high concentration is traditionally seen as strongly indicating

51 *Credit Rating Agencies Reach Agreement with New York AG*, (June 6, 2008), available at http:// www.uslaw.com/library/Corporate_Governance/ Credit_Ratings_Agencies_Reach_Agreement_New_York_Attorney_General.php?item=163101.

52 *Ibid.*

53 *See SEC Staff Examination Report*, *Supra* n. 6,

54 Securities and Exchange Commission, *Proposed Rules for Nationally Recognized Statistical Rating Organizations; Proposed Rule*, 73 Fed. Reg. 36, 212, (June 16, 2008), available at http://www.sec.gov/rules/proposed/2008/34-57967.pdf [hereinafter *SEC June 16 Proposal*]

55 *PWG Group Policy Statement*, *Supra* n. 9 at 1.

56 *FSF Report*, *Supra* n. 7 at 3-4.

57 *IOSCO CRA Report*, *Supra* n. 8 at 29-31.

58 Aaron Lucchetti and Kara Scannell, *SEC to seek Added Disclosure on Bond Rating Firms- Proposals Unlikely to Quell Criticism That More Be Done*, Wall St. J. C2 (June 11, 2008).

59 *IOSCO CRA Report*, Supra n. 8 at 14; *SEC NRSRO Report*. *Supra* n. 4 at 35.

that possibility."[60] The apprehension is further intensified by the 'two-rating norm'- the practice of getting an issue rated by two different firms.[61] While this practice ensures that the first two rating agencies don't have to compete at all, a few scholars describe the situation as a partner monopoly.[62]

The principal aim of the CRRA 2006 was to reduce the barrier to entry into the rating market. The said barrier has been the SEC's procedure for designating rating agencies as "nationally recognized statistical rating organizations" (NRSROs)- as only ratings issued by NRSROs are officially recognized under the SEC rules. The 1975 amendments to the SEC's Net Capital Rule for Brokers-Dealers apparently marked the first appearance of the term NRSRO.[63] This rule allowed brokers to calculate their net capital requirements based on credit ratings from a NRSRO designated by the SEC. Gradually the NRSRO concept was used in other contexts including both federal[64] and state legislations.[65] A 'no-action letter' issued by the SEC upon application by the candidate agency process designated a rating agency as a NRSRO. The criteria for granting the letter were unclear, and the grant of letter took a considerable time. Post-Enron, the SEC considered doing away with the category-however, it ultimately decided against it. This was perhaps because of the

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60 U.S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines* § 1.51, § 2.0 (April 8, 1997). available at http://www.usdoj.gov/atr/public/guidelines/hmg.pdf.

61 *Supra* n. 59.

62 *See* Senate Committee on Banking, Housing, and Urban Affairs, *Report to Accompany S.3850, Credit Rating Agency Reform Act of 2006*, S. Report No. 109-326, 109th Cong., 2nd Session. 1(September 6, 2006), available at http://congress.gov/cgi-bin/cpquery/ ?&sid=cp10902KMw&refer=&r_n=sr326.109&db_id=109&item=&sel=TOC_08:; *See also*, Hill, Supra n. 32 at 63-64.

63 Securities and Exchange Commission, *Net Capital Requirements for Brokers or Dealers*, 17 C.F.R. § 240.15c3-1 (2008), available at http://cfr.vlex.com/vid/19642991 *See* Kettering, *Supra* n 18 at 1695.

64 For example, Rule 2a-7 under the Investment Company Act 1940 limits money market funds to investing in only high quality short-term instruments, and NRSRO ratings are used as benchmarks for establishing minimum quality investment standards. In addition, in regulations adopted by the SEC under the Securities Act 1933, offerings of certain nonconvertible debt, preferred securities, and asset-backed securities that are rated investment grade by at least one NRSRO can be registered on Form S-3- the SEC's '*short-form*' registration statement - without the issuer satisfying a minimum public float test. Definition of the term *'mortgage related security* in Section 3(a)(41) of the Securities Exchange Act 1934, as part of the Secondary Mortgage Market Enhancement Act 1984, requires, among other things, that such securities be rated in one of the two highest rating categories by at least one NRSRO. Further, in 1989, Congress added the NRSRO concept to the Federal Deposit Insurance Act 1950, prescribing that corporate debt securities are not '*investment grade*' unless they are rated in one of the four highest categories by at least one NRSRO. The U.S. Department of Education uses ratings from NRSROs to set standards of financial responsibility for institutions that wish to participate in student financial assistance programs under Title IV of the Higher Education Act 1965. For a detailed analysis of the regulatory significance of NRSRO Ratings across financial regulations, *see SEC SOX Report*. *Supra* n. 36 at 6-8

65 For example, several state insurance codes rely, directly or indirectly, on NRSRO ratings in determining appropriate investments for insurance companies. *SEC SOX Report*, *Supra* n. 36 at 8. *See generally*, Rhodes, *Supra* n. 1 at 334-356

need of a regulatory process to keep out "fly-by-night" rating agencies.[66] However, there were opinions against the barrier,[67] and the 2006 Act finally laid down substantively lower criteria for NRSRO registration. It also subjected the SEC to a strict time-frame to grant NRSRO recognition. As per the provisions of the 2006 Act, Applicants for registration must provide "credit ratings performance measurement statistics over short-term, mid-term, and long-term periods",[68] describe "the procedures and methodologies that the applicant uses in determining credit ratings",[69] and provide certifications from at least 10 unaffiliated qualified institutional buyers, with each certificate indicating that the buyer has "used the credit ratings of the applicant for at least the 3 years immediately preceding the date of the certification."[70] Further, on receipt of the application of registration, the SEC has to act within 90 days and is to grant registration or institute proceedings to determine whether the registration should be denied.[71] Such proceedings must conclude within 120 days of the application date. While the SEC can extend the deadline on a sufficient cause, this extension must not exceed 90 days.[72] The applications which contain the prescribed information are to be granted, unless the SEC determines that (a) "the applicant does not have adequate and managerial resources to consistently produce credit ratings with integrity and to materially comply"[73] with the rating procedures it claims to follow; or (b) the applicant or person controlling the applicant has been convicted of a crime or has been punished for committing certain securities violations.[74]

The SEC's proposed initiatives in response to the economic meltdown continued the insistence on increasing competition as an answer to the rating market's shortcomings. In its report in June 2008, the SEC proposed that the information provided to the NRSRO be publicly disclosed so as to give other rating agencies an opportunity to rate the same products.[75] It also proposed that the agencies disclose augmented performance information to help the investors determine how well the agencies performed.[76]

It would be premature to say whether the efforts at boosting competition

66 *SEC SOX Report*, *Supra* n. 36 at 24, Hill, *Supra* n. 32 at 44.

67 Claire Hill, *Rating Agencies Behaving Badly. The Case of Enron*, 35 CONN. L. REV. 1145, 1152 (2003). Hill argued that the foremost problems the regulatory change should address were those resulting from market concentration in the rating agency industry and the government created near-duopoly.

68 15 U.S.C. § 78o-7(a)(1)(B)(i).

69 15 U.S.C. § 78o-7(a)(1)(B)(ii).

70 15 U.S.C. § 78o-7(a)(1)(C)(i), (a)(1)(C)(iv)(II).

71 15 U.S.C. § 78o-7(a)(2)(A).

72 15 U.S.C. § 78o-7(a)(2)(B)(i)(II), (a)(2)(B)(iii).

73 15 U.S.C. § 78o-7(a)(2)(c)(ii)(II).

74 15 U.S.C. § 78o-7(d).

75 *SEC June 16 Proposal*, *Supra* n. 54 at 36, 251; *SEC NRSRO Report*, *Supra* n. 4 at 41-42.

76 *Ibid.*

are effective in practice- it is very possible that agencies may engage in a 'competitive laxity'- competing to give the issuers, especially those from the structured finance sector, the high ratings they want.

2. Absence of Transparency: The economic crisis has given the regulators a renewed zeal in promoting rating agency transparency. The 2006 Act and the 2007 Rules addressed the issue of transparency by asking the NRSROs to make public their rating procedures and registration materials.[77] The rating agencies also are to update and amend their registrations to ensure that they remain current.[78] However, this did not result in an increase in transparency, primarily because the descriptions filed by the major rating agencies with the SEC were quite vague.

The SEC's proposed 2008 rules contain procedures aimed at enhancing transparency. It calls for agencies to disclose the frequency of rating reviews and the methods of such subsequent reviews.[79]

Further, both the 2006 Act and the 2007 Rules require disclosure of agency performance statistics.[80] Reports on the Economic Crisis suggest that insufficient transparency in this area was one of the major reasons for the failure of the rating mechanism.[81] Further, the SEC recommended that the agencies review their reports to ensure compliance with the existing rules.[82] The SEC's 2008 proposed rules contain a number of disclosure provisions intended to improve transparency.[83] The SEC proposal calls for agencies to disclose how frequently credit ratings are reviewed, whether different models or criteria are used for reviews as opposed to initial ratings, whether changes to models and are applied retroactively to existing ratings. For structured products, the SEC proposal calls for disclosure of how information about verification performed on, and the quality of the originators of, the underlying assets is incorporated into ratings.[84]

However, most rating agencies usually issue an annual performance report. This, coupled with the SEC's refusal to prescribe a standard format for the disclosures, makes it extremely unclear whether the regulatory effort has increased transparency at all.

3. Conflicts of Interest:[85] There is also a potential conflict of interest involved is rating mechanism, as the agencies are paid by the issuers of the products they are

77 15 U.S.C. §78o-7(a)(3).

78 15 U.S.C. §78o-7(b).

79 *SEC June 16 Proposal*, *Supra* n. 54 at 36, 233-34.

80 15 U.S.C. §§ 78o-7(a)(1)(B)(i), 78o-7(b)(1)(A).

81 *FSF Report*, *Supra* n. 7 at 33.

82 *SEC Staff Examination Report*, *Supra* n. 6 at 15, 17.

83 *SEC June 16 Proposal*, *Supra* n. 54 at 36, 231-33.

84 *Ibid.* at 36, 233-34, 36, 251-52.

85 For an excellent analysis of this issue, *see* Arthur Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 Am J. Comp L. 341, 342-343 (2006). *See also*, *SEC SOX Report*, *Supra* n. 42 at 23; Stephane

rating. As CRAs are paid by the issuers for the ratings and thus, to retain the client it is possible that they may issue favourable ratings, slowly downgrade and quickly upgrade them. Furthermore, the rating agencies also offer ancillary services, making themselves vulnerable to the temptations of compromising rating accuracy to lure the issuers into purchasing these other services. That is to say, the agencies may use the threats of lower rating or unfavourable rating modification to force the issuers into buying such services. As mentioned earlier,[86] the agencies may also indulge in notching to maximize rating fee gains whereby they either refuse to rate or threatn to downgrade ratings on asset backed securities unless a significant part of the asset pool is rated by them.

As a response to such concerns, the 2006 Act mandated the SEC to formulate rules relating to agency's conflict of interests.[87] The rules framed by the SEC in this regard are very limited. They relate mostly to an enumeration of situations of conflicts.[88] The SEC does not concern itself with the substantive review of the procedure the rating agencies must simply disclose that they are paid by issuers, and have taken steps to manage this "conflict".[89] Further, the agencies have to appoint a Compliance Officer for monitoring compliance with the said rules.[90] In June 2008, the SEC proposed further rules in this regard, with special emphasis on structured financial products.[91]

These rules seem to suggest that no deliberate intervention is needed to deal with such conflict of interests. Although the SEC has the authority to ban agency conflict of interests generally,[92] and although it recognizes the existence of such a conflict,[93] it has refused to consider this option.

Further, on July 1, 2008 the SEC issued three further rule proposals aimed at responding to ongoing concerns regarding the role and importance of credit

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Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 McGILL L.J. 617, 634-637 (2006); Carol Ann Frost, *Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies*, 15-19 (June 16, 2006), Working Paper series, available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=904077.

86 *See Supra* n. 53-55.

87 15 U.S.C. §78o-7(h)(2).

88 For example, the rules specify that receiving payment from an obligor (issuer/underwriter) for rating or for ancillary services when they have paid for a credit rating or permitting insiders to directly own securities of, or have other direct ownership interests in, or have non-ordinary business relationship with, issuers or obligors who are rated by the NRSRO would amount to situations of conflict.

89 17 C.F.R. § 240.17g-5(a)(2).

90 *SEC 2007 Rule*, *Supra* n. 42 at 56.

91 *SEC June 16 Proposal*, *Supra* n. 54 at 36, 218-28.

92 *See* 15 U.S.C. § 78o-7(h)(2).

93 17 C.F.R. § 240.17g-(h)(1)-(3); SEC *NRSRO Report*, *Supra* n. 4 at 41.

ratings.[94] These proposed rules include norms related to conflicts of interest, disclosure and reporting obligations and record-keeping obligations.[95] While it is believed that the proposed amendments would eliminate references to these ratings in numerous SEC rules and forms, it has also been alleged[96] that the proposed rules aimed at addressing problems in the asset-backed markets are not drafted based on the existing definition of asset-backed securities found in Item 1101(c) of Regulation AB.[97] Instead, certain of these proposed rules apply to a new category of securities described as "any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction." The SEC June 16 Proposal address this departure from the existing asset-backed definition by noting that the proposed language was used to "ensure the inclusion of ratings actions for credit ratings of structured finance products that do not meet the narrower statutory definition of issuers of asset backed securities."[98]

As the rules are specifically drafted to encompass more than those securities subject to Regulation AB, structured finance market participants should carefully monitor the rule proposal process and evaluate existing and contemplated structures that may be considered Asset Pool Securities. In particular, these rules would require extensive public disclosure of information shared with NRSROs rating Asset Pool Securities if the issuer pays for the rating.[99]

V. Regulatory Framework for Credit Rating Agencies in The European Union

In the European Union, Annexure VI, Part 2 of Directive 2006/48/EC on the recognition of CRAs, provides the requirements to be complied with for recognizing a CRA. For example, the procedure for assigning credit assessments must be systematic and accurate,[100] and such credit assessments must be subject to continuous review.[101] Further, the methodology adopted by the CRAs must be publicly disclosed.[102]

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94 Securities and Exchange Commission, *References to Ratings of Nationally Recognized Statistical Rating Organizations*, (July 1, 2008), available at http://edocket.access.gpo.gov/2008/pdf/E-8-15280.pdf and http://edocket .access .gpo.gov/2008/pdf/E-8-15281.pdf [hereinafter *SEC July 1 Proposal*].

95 *Ibid.*

96 Amy M. Baumgardner, (et al.), *United States: SEC Proposals For Credit Rating Agency Reform: Potential Impact On The Asset-Backed Markets*, available at http://www.mondaq.com/article.asp?articleId=64966&login=true&nogo=1.

97 Regulation AB is a comprehensive set of new rules and amendments introduced in 2004 by the SEC that address the registration, disclosure and reporting requirements for asset-backed securities (ABS) under the Securities Act of 1933 and the Securities Exchange Act of 1934.

98 *SEC June 16 Proposal*, *Supra* n. 54 at 36, 218-28.

99 *SEC July 1 Proposal*, *Supra* n. 94.

100 No. 1.1 and 1.2 Annex VI, Part 2, Directive 2006/48/EC.

101 No. 4, *Ibid.*

102 No. 7, *Ibid.*

While Directive 2006/48/EC lays down the conditions under which authorities are permitted to accept an external credit assessment, this instrument does not regulate the licensing and supervision of CRAs in the EU as such.[103] This is categorically conceded in the Directive's preamble, which at the same time emphasizes that 'appropriate future authorisation and supervisory process for rating agencies need to be kept under review.'[104]

Yet, this is not to say that the functioning of CRAs is not subjected to any kind of regulation at all. Currently, CRAs active on the territory of EU are mainly regulated by the International Organization of Securities Commission (IOSCO),[105] which sets standards for international securities markets.[106] The importance of the IOSCO Code may be questioned, as some of its provisions are abstract and generic and, more importantly, it lacks any enforcement mechanisms.[107] However, Committee of European Securities Regulators[108] reports annually to the EU on the extent to which CRAs follow this code.[109]

CESR considers the IOSCO Code as 'the standard on which CRA conduct of business should be assessed',[110] an approach which is shared by the EU.[111]

As across the globe, the regulatory approach to CRAs has also come under criticism in EU, especially since the global financial crisis.[112] In the aftermath, both the European Securities Markets Expert Group (ESME) and the CESR prepared detailed assessments of the role of CRAs in the crisis. Interestingly, both the bodies rejected an expansive regulatory approach to CRAs and considered the IOSCO

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103 In fact, there are several related Directives in this regard- Directive 2003/125/EC implementing Directive 2003/6/EC concerning fair presentation of investments recommendations and disclosure of interest, and Directive 2004/39/EC concerning markets in financial instruments.

104 Preamble, para 39, Directive 2006/48/EC.

105 *See generally, Supra* n. 8.

106 Technical Committee of the International Organization of Securities Commissions, *Code for Conduct Fundamentals for Credit Rating Agencies* (May, 2008), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf [hereinafter *IOSCO Code*]

107 For instance, CRAs are merely invited to give reasons if they do not comply with the code. *See*, No. 4.1, *IOSCO Code, Ibid.*

108 Committee of European Securities Regulators (CESR) is an independent advisory group to the European Union. It is composed of the national supervisors of the EU securities markets.

109 *See, for example*, Committee of European Securities Regulators, *CESR's Second Report to the European Commission on the compliance of Credit Rating Agencies with the IOSCO Code and The role of Credit Rating Agencies in Structured Finance*, (May, 2008), available at http://www.cesr-eu.org/popup2.php?id=5049. [hereinafter *CESR Report*].

110 *CESR Report, Ibid.* at 3.

111 The Preamble to the Proposed Regulation by the EU *considers the revised IOSCO Code of conduct to be the global benchmark. See*, European Commission, *Proposal of the European Parliament and of the Council on Credit Rating Agencies*, COM (2008), 704 final, 2008/0217 (COD), available at http://ec.europa.eu/internal_market/securities/docs/agencies/proposal_en.pdf. [hereinafter *Proposed Regulation*].

112 *See generally, Supra* n. 6-9. *See also*, B. J. Kormos, *Quis Custodiet Ipsos Custodes- Revisiting Rating Agency Regulation*, 4 Int'l Bus. L. J. 569 (2008).

Code sufficient for the purpose. While the ESME believed that the incremental benefits of regulation would not exceed the costs,[113] the CESR found no evidence that regulation of the credit rating industry would have had an effect on the issues which emerged with ratings of US subprime backed securities.[114] To their credit, both the reports acknowledge that additional steps are necessary to ensure a transparent functioning of the CRAs. Thus, the CESR report calls for the formation of a 'CRAs standard setting and monitoring body',[115] while the ESME report advocates that the major CRAs should agree on 'a set of measurement principles and framework which would become the market norm for evaluating the performance and success of rating agencies.'[116]

In a firm distinction to the ESME and the CESR Reports, the European Commission has preferred a binding regulatory approach, questioning the sufficiency of self regulation and the IOSCO Code.[117] The Proposed Regulation by the European Commission determines four comprehensive objects intended at reforming the mode of issuing credit ratings. These include avoiding conflicts of interest, improving qualities of methodologies, setting disclosure obligations and ensuring an efficient surveillance framework.[118]

The Proposed Regulation does not require all CRAs functioning in the EU to subject themselves to the registration process. Article 4(1) of the proposed Regulation however stipulates that financial bodies can use only those credit ratings for *regulatory purposes* which have been issued by an agency both established and registered in the EU. Article 4(2) further states that investment firms and credit institutions listed in Article 1 Regulation 2004/39/EC '*should not*' carry out operations for clients with respect to financial instruments, which have been rated by unregistered CRAs. In principle, therefore, firms and institutions are not barred from dealing in financial instruments rated by an unregistered CRA. This interpretation however doesn't correspond to Article 35, which states in broad terms that all CRAs operating in the EU have to either register or cease to issue credit ratings.[119]

The norms and procedure for registration are laid out in Articles 12-17 of the Proposed Regulations. Article 15(1) regulating the registration of CRAs refers to '*the conditions necessary for registration as set out in Title-II*', thus indicating that the

113 European Securities Markets Expert Group, *Role of the Credit Rating Agencies*, 23 (June, 2008), available at http://ec.europa.eu/internal_market/securities/esme/index_en.htm. (hereinafter *ESME Report*)

114 *CESR Report*, Supra n. 109 at 3.

115 Ibid. According to the CESR, the body should consist of senior representatives of the investor, issuer and investment firms from across various geographic areas, which should be appointed by the international regulatory community and would be accountable to those that appoint them.

116 *ESME Report*, Supra n. 113 at 21.

117 *Proposed Regulation*, Supra n 111, Explanatory Memorandum at 3.

118 Ibid. Explanatory Memorandum at S. 1.1

119 Article 35 does not differentiate between credit ratings for regulatory purposes as against any other purpose.

provisions of Title-II form the crux of the appraisal.[120] Similarly, the application for registration should also contain the relevant information mandated in Annexure II of the Proposed Regulation.[121]

The application for registration is initially submitted to the CESR, which subsequently forwards the application to the competent national authority and informs the national authorities of all other Member States.[122] The draft decision to register or refuse registration is forwarded by the national authority to the CESR. CESR can request a re-examination of the draft registration decision if it disagrees with the national authorities' negative or positive assessment of the compliance with the conditions for registration by the CRA concerned. However, this request is of a non-legally binding nature, and the national authority is not bound to accept it. The registration becomes effective after publication by the Commission in the Official Journal of the European Union.[123]

Apart from the requirements and procedure for registration, the Proposed Regulations also contain detailed rules regarding avoidance of conflicts of interest,[124] disclosure and transparency[125] and the quality of ratings.

While the Proposed Regulations have been applauded by policy-makers,[126] scholars have generally been skeptical of the initiative.[127] This skepticism emerges from the fact that neither CESR nor any other body has been given any decisive role in the regulation of CRAs operating in the EU. In addition, some scholars

120 Title II includes detailed rules relating to the avoidance of conflicts of interest (Article 5), the qualification of employees (Article 6), the rating methodologies (Article 7), the disclosure of credit ratings and other relevant information (Articles 8 and 9), as well as generally the transparency of CRAs (Article 10).

121 Annexure II sets out the information which have to be included in the application, including, *inter alia*, a description of the procedures and methodologies used to issue and maintain credit ratings, policies and procedures to identify and manage conflicts of interests, information regarding employees, compensation arrangements.

122 *Proposed Regulation*, *Supra* n. 111, Article 13.

123 *Ibid* Article 15(2)

124 For example, Article 5 and Annexure I, Section A. 2 prescribes that the administrative board of a CRA must include at least three non executive members who are independent with a non-renewable term in office not exceeding five years. Similarly, Article 5 and Annexure I, Section B stipulates the CRAs to limit their activities to credit rating and related operations, excluding consultancy or advisory services. The regulations also include a ban on the employment by rated entities or related third parties of CRA employees in a '*key management position*' for a period of 6 months after the credit rating *See* Annexure I, Section C.

125 Article 7 requires the CRAs to disclose to the public the methodologies, models and key rating assumptions it uses in the rating process. CRAs must also publish an annual transparency report (Article 10 and Annex I, Section E, Part III), and keep records of their activities (Articles 5-7 and Annex I, Section B, Points 7-9).

126 *See, for example*, EUROPEAN CENTRAL BANK, *Opinion of the European Central Bank on a Proposal for a Regulation of the European Parliament and the Council on Credit Rating Agencies*, (April, 2009), CON /2009/38, available at http://www.ecb.int/ecb/legal/pdf/en_con_2009_38.pdf.

127 *See generally*, Effi Benmelech and Jennifer Dlugosz, The Alchemy of CDO Credit Ratings, (April 22, 2009), Working Paper Series, available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1391825.

believe that a formal recognition of CRAs, at least to some extent, extent, create the false impression that now that CRAs are regulated, their ratings will be more reliable. Thus, an investor will rely excessively on the ratings by a CRA once they are under the proposed regulatory framework.[128]

VI. Regulatory Framework for Credit Rating Agencies in India: SEBI (Credit Rating Agencies) Regulations, 1999

Even outside the US and the European Union, there is a tendency amongst various countries' financial regulators to give much regulatory relevance to the work of the CRAs. In India, for example, SEBI (Credit Rating Agencies) Regulations, 1999 were formulated by the Securities and Exchange Board of India under the rule making power for investor protection, granted to it by S. 30, Securities and Exchange Board of India Act, 1992. These regulations establish a basic 'registration' model for the CRAs and give wide powers of supervision and penal sanctions to SEBI. Furthermore, a CRA is required to enter into an agreement with the client defining their mutual rights and liabilities,[129] the amount of fee charged[130] and the obligation of periodic review of the ratings,[131] amongst others. Unlike USA, no credit rating agency can operate in India without registering itself with SEBI.[132] A number of eligibility criteria have to be met by the prospective CRA before obtaining a registration certificate from SEBI. These include the prospective CRA being registered as a company under the Companies Act, 1956,[133] as well as having a minimum net worth of rupees five crores.[134] In addition, the applicant must have specified rating activity as one of its main objects in its memorandum of association.[135] The registration certificate granted by SEBI is valid for three years, subject to renewal thereafter.[136]

Several obligations are assigned to a CRA subsequent to registration under the Regulations. They are specifically required to maintain books of account and records.[137] Other obligations of the CRAs under the regulations include formulating[138] and following[139] procedure for review of ratings, disclosure of rating definitions and

128 *See generally*, Alan Morrison, *Rating Agencies, Regulation and Financial Market Stability*, Said Business School Working Paper, 5 (2008). *See also*, Frank Partnoy, *How and Why Credit Rating Agencies are not like other Gatekeepers*, San Diego Legal Studies Paper No. 07-46 (May 24, 2006) available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=900257.

129 Regulation 14 (a), SEBI (Credit Rating Agencies) Regulations, 1999.

130 Regulation 14 (b), SEBI (Credit Rating Agencies) Regulations, 1999.

131 Regulation 14 (c), SEBI (Credit Rating Agencies) Regulations, 1999.

132 Regulation 12(1), SEBI (Credit Rating Agencies) Regulations, 1999

133 Regulation 5(a), SEBI (Credit Rating Agencies) Regulations, 1999.

134 Regulation 5(c), SEBI (Credit Rating Agencies) Regulations, 1999.

135 Regulation 5(b), SEBI (Credit Rating Agencies) Regulations, 1999

136 Regulation 9(2), SEBI (Credit Rating Agencies) Regulations, 1999.

137 Regulation 21, SEBI (Credit Rating Agencies) Regulations, 1999.

138 Regulation 16, SEBI (Credit Rating Agencies) Regulations, 1999.

139 Regulation 24, SEBI (Credit Rating Agencies) Regulations, 1999.

rationale,[140] and refusing to rate securities issued by entities which are connected with a promoter or the rating agency itself.[141]

In addition, under Regulation 13, SEBI has made it mandatory for the CRAs to abide by the 'Code of Conduct' which is contained in the Third Schedule annexed to the regulations.[142] Amongst others, the code mandates the CRAs to make all efforts to protect the interests of investors, to exercise due diligence in matters of rating securities, and to ensure good professional ethics and corporate governance. While the code is said to be open textured[143] and containing general obligations,[144] it is settled that the code has legal enforceability.[145]

Finally, it is imperative to note certain India-specific features in comparison to the credit rating mechanism in USA. Unlike in US, where credit rating is obtained on a voluntary basis by the issuers, paragraph 2.5.1A of the SEBI (Disclosure and Investor Protection) Guidelines, 2000 makes it mandatory for debt issuers to obtain a credit rating from at least one CRA as a condition precedent to such issue. Similarly, a compulsory mechanism of grading initial public offerings has been formulated by SEBI,[146] thus extending the scope of credit ratings from debt to equity markets. A similar approach is missing in the US, which increases the comparative significance of CRAs for Indian capital markets.[147] In addition, the Indian banks are in the process of shifting to the Basel II capital adequacy norms, wherein the Reserve Bank of India has advised the banks to use 'Standardized Approach' for measuring credit risk. This standardized approach for measuring credit risk requires them to rely upon ratings provided by CRAs for assigning risk weights to their financial assets and obligations.[148]

VII. Solutions-Alternatives

Therefore, the problems identified are that the rating agencies issued misleading ratings for novel products leading up to the economic crisis- partly because they

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140 Regulation 18, SEBI (Credit Rating Agencies) Regulations, 1999.

141 Regulation 27, SEBI (Credit Rating Agencies) Regulations, 1999.

142 The Third Schedule to the Regulations was substituted by the SEBI (Credit Rating Agencies) (Second Amendment) Regulations, 2003, w.e.f. October 1, 2003. Earlier it was amended by the SEBI (Investment Advice by Intermediaries) (Amendment) Regulations, 2001, w.e.f. May 29, 2001.

143 *See generally*, Tarun Jain and Raghav Sharma, *Credit Rating Agencies in India. A Case of Authority without Responsibility*, (2008) 3 Comp. L. J. 89-109.

144 *Ibid.*

145 *See generally*, *India Cements Investment Services Ltd. v. SEBI*, [2003] 42 SCL 563 (SAT); *Nirmal Bang Securities Pvt. Ltd. v. SEBI*, [2004] 49 SCL 421; *Pavak Securities Ltd. v. SEBI*, [2005] 63 SCL 455 (SAT).

146 Paragraph 2.5A, SEBI (Disclosure and Investor Protection) Guidelines, 2000.

147 *See generally*, Tarun Jain and Raghav Sharma, *Supra* n. 143.

148 Reserve Bank of India, *Prudential Guidelines on Capital Adequacy and Market Discipline: Implementation of the New Capital Adequacy Framework*, DBOD.No.BP. 1151/21.06.0001/2006-07 (March 20, 2007), available at http://rbidocs.rbi.org.in/rdocs/notification/PDFs/76407.pdf.

were being paid well to do so, partly because there wasn't enough regulatory deterrent and partly because they simply did not know what they were doing. As the investors did not know the quality of the ratings on these new instruments, they rationally relied upon the ratings, leading to theirs and the larger financial system's detriment.

This problem could be resolved either by deterring rating agencies from issuing such low quality ratings, or by making their quality known to the investors beforehand. A feasible way to do this would be to subject rating agencies to disgorgement of profits derived from ratings on new instruments which turn out to be of low quality, unless the agency discloses such low quality at the time of rating.[149]

This recommendation removes the impetus of the agencies to issue unrevealed poor ratings and permits investors to decide for themselves whether to use low quality ratings. It also avoids unnecessary, error-prone, and irrelevant inquiries into the agency's "intent to deceive" and the *ex ante* "reasonableness" of its determinations that would be required under fraud or negligence rules. Neither does it depend on administrative caution to the same extent as a pending proposal under which the SEC would have to approve ratings on novel instruments in advance.[150]

Further, one of the reasons why CRAs have been found wanting is that S&P, Moody's and Fitch control most financial markets. Therefore, a corrective measure would also be to increase the level of competition. Higher competition and a better balance between income maximization and investors' interests could be achieved by the setting up of a majority government owned CRA. It is pertinent now that standards are set for the credit rating functions, since they provide critical inputs for debt and equity issuance and investment exercises. A public sector CRA should be moderate in its appraisals and specify instructions for investors on how best to interpret its ratings.

In relation to better transparency, an alternative rating scale for structured finance products or adding scales to the existing rating scales are widely seen as a possible solution. This proposal is endorsed particularly by central banks and market supervisors.[151]

One of the significant issues which arise in this quagmire concerns mechanisms of imputing liability to the CRAs. The problem in this regard lies in the fact that the

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149 John C. Coffee Jr. *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B. U. L. Rev 301. 349-352 (2004).

150 *SEC June 16 Proposal*, *Supra* n. 54.

151 *IOSCO CRA Report*, *Supra* n. 8, calls for a distinction to be made in future between ratings of structured finance products on the one hand and traditional bonds on the other hand.

ratings by CRAs are considered as opinions,[152] which are generally protected under the First Amendment.[153] This protection has made it more difficult to make these agencies liable for damages.[154] It is possible, at least in theory, to use tort of negligent misrepresentation as a basis of imputing liability to CRAs when investors justifiably rely on the false information supplied by the rating agency.[155] However, in practice the First Amendment protects them from liability for negligent misrepresentation; rather they are liable only if they act with intent and a reckless disregard for the truth.[156] If the ratings were paid for, then there may also be contract liability but that would require a showing that an express or implied agreement had been breached. In addition there may be contract disclaimers to limit liability.[157] It has also been argued that investors may have a claim as third party beneficiaries of the contract between the credit rating agency and the issuer because the value of the rating is in those third party users in the market.[158] However, a similar claim was rejected in Illinois because there was no evidence of intent to confer a benefit on a third party in the original contract.[159] Thus, it is evident that credit rating agencies have rarely been sued successfully in the US because of the difficulties of proving liability under various theories, as well as the First Amendment protection granted to them by the courts.

As far as the lacunae in the Indian approach are concerned, most of them stem from the fact that the disclosure standards in India are very poor when compared to international standards. For example, while the Code of Conduct mandates the Indian CRAs to frame their own mechanism for governing their internal operations,[160] no public disclosure of such a mechanism is mandated. It is imperative to fill this 'accountability gap'. Further, while it can be argued that the Indian legal regime does not exclude a possibility of an action against an Indian CRA on the grounds of fraud and negligence, the silence of law creates a practical immunity. The problem is compounded by the fact that 'rating' is defined by SEBI in terms of an *opinion*,[161] and CRAs are allowed to add disclaimers stating that the ratings are not

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152 Carstern Thomas Ebenroth and Thomas Dillon, *The International Rating game: An Analysis of the Liability of Rating Agencies in Europe, England, and the United States*, 24 Law & Pol'y Int'l Bus. 703 (1993) *See also, First Equity Corporation of Florida v. Standard & Poor's Corporation*, 869 F. 2d 175 (2d Circuit 1989); *Ollman v. Evans*, 750 F. 2d 970 (D.C. Circuit 1984).

153 As per the First Amendment to the Constitution of United States of America, "*Congress shall make no law ... abridging the freedom of speech, or of the press.*"

154 *See generally*, Arthur Pinto, *Supra* n 3 at 353-354 (2006).

155 Restatement (Second) of Torts, § 552 (1977).

156 *First Equity Corporation of Florida v. Standard & Poor's Corporation*, 869 F. 2d 175, 259 (2d Circuit 1989). *See also, Jefferson County District v. Moody's Investors Services Inc.* 175 F. 3d 848, 852-857 (10th Circuit 1999).

157 *Gale v. Vault Line Inc* 640 F. Supp. 967, 969-971 (1986).

158 For this argument, *see generally*, Arthur Pinto, *Supra* n. 3.

159 *Quinn v. McGraw Hill Co.* 168 F. 3d 331, 335 (7th Circuit 1999)

160 Principle 19, Code of Conduct, Third Schedule, SEBI (Credit Rating Agencies) Regulations, 1999.

161 Regulation 2(q), SEBI (Credit Rating Agencies) Regulations, 1999.

recommendations to buy or sell a security and the investor must not rely solely on them to make an investment choice.[162] To remedy such a situation, the CRAs should be made expressly liable to the investors for any act of fraud or negligence. Such a provision will act as deterrence and will ensure responsible application by the CRAs.

VIII. Conclusion

The subprime crisis has shown how problematic it is that ratings are being used increasingly for regulatory purposes. This practice has made supervisors and CRAs dependent on one another. Such a situation definitely gives a cause for concern. This is a problematic state of affairs, and it is essential to consider what consequences follow from it. The current economic crisis has necessarily revived the issue of the best possible management and supervision of CRAs, more so as the oligopolistic nature of the ratings market remains disappointing. The regulatory measures to date are critically limited in their ability to bring about control and transparency in rating agency mechanisms. A clear understanding of the role and capabilities of supervisors when implementing and overseeing such necessary regulatory measures is needed.

It is arguable whether a greater regulation of CRAs would have prevented the worldwide financial crisis. In this perspective, an analysis of how to optimize ratings of structured finance products is highly desirable. However, it is only an elementary but not a sufficient response to the numerous issues highlighted by the challenging circumstances of the financial markets in recent times.

162 Regulation 18, SEBI (Credit Rating Agencies) Regulations, 1999.