

---

# Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach

---

Stéphane Rousseau\*

---

Credit rating agencies ("CRAs") play a vital role in enabling financial markets to operate efficiently by acting as informational intermediaries specializing in the appraisal of the creditworthiness of corporations that issue debt. Despite their importance, however, rating agencies remain unregulated private institutions. The recent wave of corporate scandals has led many to call their contribution to market efficiency into question. In light of such criticism, studies conducted by lawmakers and regulators sought to further examine the role and effectiveness of CRAs. Although the studies revealed no particular wrongdoing, they warned of potential problems that could disrupt the smooth operation of capital markets. These problems relate to the reliability and integrity of ratings, as well as to possible anti-competitive practices on the part of CRAs. These potential problems are worrisome given that CRAs wield considerable power over issuers and investors. Fundamentally, the main theme underlying the criticism of CRAs relates to their accountability towards market participants. In a perfectly functioning market, the fact that CRAs have such significant power would not elicit such concern since they would be accountable to both issuers and investors. The real world departs from this ideal and market failures may lead to a divergence between, on the one hand, the interests of CRAs, and, on the other hand, those of issuers and investors.

A review of the legal and institutional environment indicates that there is a dearth of mechanisms designed to offset these market failures. Reputation is the primary mechanism that acts to restrain opportunistic behaviour on the part of rating agencies. Thus, a potential accountability gap exists, leading to an imbalance between CRAs' power, and the likelihood of holding them responsible for their use of this power.

It is in this context that regulators have examined possible methods of enhancing the accountability of rating agencies. In light of the recent flurry of regulatory initiatives, the purpose of this study is to discuss the attitude that Canadian regulators should adopt in approaching CRA accountability. The study favours the approach put forward by the International Organization of Securities Commissions. It proposes implementing this approach through a disclosure strategy that would contribute to enhancing the accountability of CRAs, not only by reinforcing existing reputational pressures that guard against opportunism, but also by introducing an additional level of regulatory supervision over CRAs that could hold them responsible for such behaviour.

Les agences de notation de crédit («ANC») jouent un rôle crucial pour l'efficacité des marchés en agissant à titre d'intermédiaires informationnels se spécialisant dans l'évaluation de la solvabilité des entreprises se finançant par voie d'endettement. Malgré leur importance, les agences de notation ne sont cependant pas réglementées. Depuis la récente vague de scandales financiers, plusieurs remettent en cause leur contribution à l'efficacité des marchés. À la lumière de ces critiques, les législateurs et les régulateurs ont mené des études examinant plus en détails le rôle et l'efficacité des ANC. Bien qu'elles n'aient révélé aucun abus, les études mettent en garde contre des problèmes qui pourraient nuire au bon fonctionnement du marché. Ces problèmes concernent la fiabilité et l'intégrité des notations, de même que les pratiques des agences qui pourraient s'avérer anti-concurrentielles. Ces problèmes sont préoccupants étant donné que les ANC exercent une influence considérable sur les émetteurs et les investisseurs. Essentiellement, le thème récurrent de ces critiques concerne l'imputabilité des ANC. Dans un marché parfaitement efficient, le pouvoir des ANC ne soulèverait pas d'inquiétude puisqu'elles seraient imputables à l'égard des émetteurs et des investisseurs. Dans la réalité, des imperfections du marché peuvent mener à une divergence entre, d'une part, les intérêts des ANC et, d'autre part, ceux des émetteurs et des investisseurs.

Un examen de l'environnement légal et institutionnel révèle l'absence de mécanisme pour corriger les imperfections du marché. La réputation est le principal mécanisme disciplinaire pour endiguer l'opportunisme des ANC. Ainsi, il existe une lacune pouvant mener à un déséquilibre entre le pouvoir des ANC et la possibilité de les rendre responsable pour leurs décisions.

Dans ce contexte, les régulateurs ont examiné des moyens d'accroître l'imputabilité des ANC. L'objectif de la présente étude est de discuter de l'approche pouvant être employée par les régulateurs au regard des initiatives de réformes. L'étude favorise l'approche proposée par l'Organisation internationale des commissions de valeurs («OICV»). Elle propose de mettre en œuvre la proposition de l'OICV par une stratégie fondée sur la divulgation. Cette stratégie permet d'accroître l'imputabilité des ANC non seulement en renforçant les sanctions réputationnelles, mais aussi en ajoutant une supervision réglementaire pouvant les rendre responsables pour leurs conduites opportunistes.

---

\* Associate Professor and Chair in Business Law and International Trade, Faculty of Law, Université de Montréal. This paper is derived from a report commissioned by the Capital Markets Institute of the University of Toronto. The author wishes to thank the personnel of the Capital Markets Institute for their time, input, and encouragement in preparing this study, including Paul Halpern, Doug Harris, and Atanaska Novakova. He is also grateful to Paul Bourque, Jerry Goldstein and Robert Nicholls who made insightful comments on an earlier draft of this work. Finally, the author wants to thank Éric Archambault and Philippe Kattan for their capable research and editorial assistance. The research for this paper is current as of 1 January 2006.

© Stéphane Rousseau 2006

To be cited as: (2006) 51 McGill L.J. 617

Mode de référence : (2006) 51 R.D. McGill 617

---

<b>Introduction</b>	620
<b>I. Background on the Role and Regulation of Credit Rating Agencies</b>	621
A. <i>Credit Rating Agencies and the Operation of Capital Markets</i>	622
B. <i>An Overview of the Rating Agency Industry</i>	624
C. <i>Current Regulation of Ratings and Credit Rating Agencies</i>	626
<b>II. Concerns Over Credit Rating Agencies' Accountability</b>	627
A. <i>Potential Failures in the Credit Rating Market</i>	627
1. Sources of Market Failures	627
a. <i>Imperfect Competition</i>	627
b. <i>Agency Problems Affecting Credit Rating Agencies</i>	629
2. A Look at the Empirical Evidence Surrounding Market Failures	631
a. <i>The Value of Credit Ratings</i>	631
i. The Reliability of Ratings	631
ii. The Timeliness of Rating Changes	632
iii. The Relevance of Ratings	633
b. <i>The Potential Conflicts of Interest of Credit Rating Agencies</i>	634
c. <i>Abusive Practices of Credit Rating Agencies</i>	635
i. The Practice of "Notching"	635
ii. Unsolicited Ratings	636
B. <i>Legal and Institutional Constraints Influencing the Behaviour of Credit Rating Agencies</i>	637
1. The Role of Reputation in Shaping the Behaviour of Rating Agencies	637
2. Issuer Disclosure	640
3. The Influence of Securities Regulation on the Transparency and Dissemination of Ratings	641
4. The Liability of Credit Rating Agencies	642
C. <i>Summation: Is There an Accountability Gap?</i>	642
<b>III. Enhancing the Accountability of Credit Rating Agencies: The Role of Regulation</b>	643
A. <i>The Regulation of Credit Rating Agencies: Policy Perspectives</i>	644
1. The Goals of Securities Regulation	644
a. <i>Market Efficiency</i>	644
b. <i>Investor Protection</i>	645
2. The Importance of a Cost-Effective Regulatory Regime	646
B. <i>An Overview of the Current Proposals to Enhance the Accountability of Credit Rating Agencies</i>	647

1. The IOSCO Code of Conduct Fundamentals for Credit Rating Agencies	647
a. <i>The Rating Process</i>	647
i. The Quality of the Rating Process	647
ii. Monitoring and Updating	648
iii. The Integrity of the Rating Process	648
b. <i>Credit Rating Agencies Independence and Avoidance of Conflicts of Interest</i>	649
i. General Principles	649
ii. Procedures and Policies	649
iii. Analyst and Employee Independence	650
c. <i>Credit Rating Agencies' Responsibilities to the Investing Public and to Issuers</i>	650
i. Transparency and Timeliness of Ratings Disclosure	650
ii. Treatment of Confidential Information	651
d. <i>Disclosure of the Code of Conduct</i>	651
2. The Securities and Exchange Commission's Proposal to Define the Concept of Nationally Recognized Statistical Rating Organization	651
a. <i>Issuance of Publicly Available Ratings that Are Current Assessments of the Creditworthiness of Obligor with Respect to Specific Securities</i>	652
b. <i>Recognition of Credibility and Reliability by the Financial Markets</i>	653
c. <i>Systematic Procedures to Ensure Credible and Reliable Ratings</i>	653
C. <i>A Critical Look at Regulatory Strategies for Implementing Accountability-Enhancing Rules of Conduct</i>	653
1. Self-Regulation with a Voluntary Code of Conduct	654
2. Strategies Regulating both Entry and Conduct	656
a. <i>Supervised Self-Regulation</i>	657
b. <i>Registration Model</i>	658
D. <i>Strengthening Market-based Solutions through a Measured Regulatory Intervention</i>	660
1. A Disclosure Strategy to Reinforce Private Accountability Mechanisms	660
2. The Implementation of the Disclosure Strategy	661
<b>Conclusion</b>	664

---

## Introduction

Since their inception at the beginning of the twentieth century, credit rating agencies (“CRAs”) have emerged as informational intermediaries specializing in the appraisal of the creditworthiness of corporations.<sup>1</sup> Gradually, these institutions have become central to the financial markets’ infrastructure through their role in rectifying information asymmetries that exist between issuers and investors. At the same time, CRAs have gained considerable clout over market participants as their assessments of creditworthiness have come to be viewed as authoritative.<sup>2</sup> Despite their importance, rating agencies remain unregulated private institutions.

Whereas rating agencies have always been subject to periodic criticism, the recent wave of corporate scandals has led many to call their contribution to market efficiency into question.<sup>3</sup> Commentators have criticized CRAs for failing to play their role of watchdog. Others have questioned their reliability in general. In light of such criticism, studies conducted by lawmakers and regulators sought to further examine the role and effectiveness of CRAs.<sup>4</sup> Although the studies revealed no particular wrongdoing, they warned of potential problems that could disrupt the smooth operation of capital markets. These studies formed the basis on which the International Organization of Securities Commissions (“IOSCO”), the Securities and

---

<sup>1</sup> See generally Timothy J. Sinclair, *The New Masters of Capital* (Ithaca: Cornell University Press, 2005) at 22-30; Richard Cantor & Frank Packer, “The Credit Rating Industry” (1995) 5:3 J. Fixed Income 10.

<sup>2</sup> Steven L. Schwarcz, “Private Ordering of Public Markets: The Rating Agency Paradox” (2002) U. Ill. L. Rev. 1 at 2.

<sup>3</sup> For early criticism, see Francis A. Bottini, “An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies” (1993) 30 San Diego L. Rev. 579; Frank Partnoy, “The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies” (1999) 77 Wash. U.L.Q. 619 [Partnoy, “Siskel and Ebert”].

<sup>4</sup> See e.g. International Organization Of Securities Commission, Technical Committee, *Report of the Activities of Credit Rating Agencies* (September 2003) [IOSCO Report], online: International Organization of Securities Commissions <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf>>; U.S., Securities and Exchange Commission, *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets* (January 2003) [Report on the Role and Function of CRAs], online: United States Securities and Exchange Commission <<http://www.sec.gov/news/studies/credratingreport0103.pdf>>; U.S., Report of the Staff to the Senate Committee on Governmental Affairs, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs* (8 October 2002) [Watchdogs Report], online: United States Senate <[http://hsgac.senate.gov/\\_files/100702watchdogsreport.pdf](http://hsgac.senate.gov/_files/100702watchdogsreport.pdf)>; U.S., *Rating the Raters: Enron and the Credit Rating Agencies Hearing Before the U.S. Senate Committee on Governmental Affairs*, 107<sup>th</sup> Cong. (Washington, D.C.: United States Government Printing Office, 2002) [Rating the Raters], online: United States Senate <<http://hsgac.senate.gov/032002witness.htm>>.

Exchange Commission (“SEC”), and the European Commission founded their recent policy initiatives.<sup>5</sup>

The main theme underlying such criticism relates to CRAs’ accountability towards market participants, by questioning whether the power allotted to rating agencies is balanced by equally effective mechanisms designed to ensure that they act in the interests of market participants. In light of the recent flurry of regulatory initiatives, the purpose of this study is to discuss the attitude that Canadian regulators should adopt regarding credit rating agencies. First, we offer some background information on the role and regulation of credit rating agencies. We then move to an analysis of the concerns raised by various CRA activities. We also examine the legal and institutional mechanisms designed to direct the behaviour of rating agencies as well as their effectiveness with respect to minimizing the impact of market failures. Finally, we identify the initiatives recently put forward by the SEC and the IOSCO. We argue that while both of these initiatives deal with similar issues, the IOSCO Code can be more readily transplanted in national regulations than the SEC rule, which is idiosyncratic to the American system. We then assess the options available to implement that IOSCO Code. We conclude by recommending that securities regulators implement the IOSCO Code in Canada using a disclosure-based approach.

## I. Background on the Role and Regulation of Credit Rating Agencies

Since the publication of *Moody’s Analyses of Railroad Investments* in 1909, credit rating agencies have become central institutions in financial markets.<sup>6</sup> They emerged to rectify some of the information asymmetries that exist in lending relationships. Throughout the last century, CRAs have adapted to ever evolving financial markets. Initially focused on railroads, industrial corporations, and financial institutions, CRAs now rate every type of issuer, both national and international. Ratings cover traditional fixed-income securities such as bonds, as well as new “structured” financial instruments such as asset-backed securities. Increasingly, the opinions of CRAs carry more importance for market participants. Regulation frequently makes reference to ratings, giving them a normative dimension in certain instances. Aside from that normative aspect, market participants rely on ratings not necessarily

---

<sup>5</sup> International Organization of Securities Commissions, *Code of Conduct Fundamentals for Credit Rating Agencies* (December 2004), online: International Organization of Securities Commissions <<http://www.iosco.org/library>> [IOSCO Code]; Securities and Exchange Commission, *Definition of Nationally Recognized Statistical Organization*, 78 Fed. Reg. No. 70 (2005) [NRSRO Definition], online: United States Securities and Exchange Commission <<http://www.sec.gov/rules/proposed/33-8570.pdf>>. See also Committee of European Securities Regulators, *CESR’s Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies* (CESR/05-1396) (March 2005) [CESR’s Technical Advice], online: Euractive.com <[http://www.euractiv.com/29/images/CESR%20credit%20rating%20agencies%20March%2005\\_tcm29-151345.pdf](http://www.euractiv.com/29/images/CESR%20credit%20rating%20agencies%20March%2005_tcm29-151345.pdf)>.

<sup>6</sup> See Sinclair, *supra* note 1 at 22-27.

because the agencies are right, “but because they are thought to be an authoritative source of judgments.”<sup>7</sup>

### **A. Credit Rating Agencies and the Operation of Capital Markets**

Credit rating agencies provide an evaluation of the creditworthiness of issuers, which is essentially an assessment of how likely they are to make timely payments on their debts in general.<sup>8</sup> They also offer ratings of individual debt instruments that indicate the probability of default or delayed payment with respect to that particular security. The ratings do not express opinions on whether the particular debt instruments should be bought or sold. They are only intended to convey information regarding the relative safety of the securities. Since their primary function is to evaluate credit risk, CRAs do not assess the economic appeal of investments.<sup>9</sup> Individual investors may prefer to purchase less creditworthy instruments as they receive appropriate compensation for the added risk acceptable. Furthermore, a credit rating does not express the agency’s opinion of the actual value of an issuer’s equity securities.

The activities of CRAs can contribute to the efficiency of capital markets by rectifying some of the information asymmetries that exist between issuers and investors.<sup>10</sup> Inevitably, information asymmetry exists in the debt market because issuers have superior information regarding their creditworthiness than do investors.<sup>11</sup> Consequently, this discrepancy enables issuers to exaggerate their credit quality in order to get the highest price for their securities, leaving to potential investors the task of distinguishing between good and bad issues.

In the absence of CRAs, investors could theoretically attempt to conduct their own research.<sup>12</sup> In practice, it is doubtful that such an initiative would prove cost-effective for most investors.<sup>13</sup> Because of the greater size of their investments and expertise, some institutional investors may find it economically justifiable to do their own research of the credit quality of issuers. However, their research remains costly

---

<sup>7</sup> *Ibid.* at 2.

<sup>8</sup> *IOSCO Report*, *supra* note 4 at 3; *Watchdogs Report*, *supra* note 4 at 98.

<sup>9</sup> Amy K. Rhodes, “The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?” (1996) 20 *Seton Hall Legis. J.* 293 at 315-316; Schwarcz, *supra* note 2 at 6.

<sup>10</sup> *IOSCO Report*, *supra* note 4 at 3; Gregory Husisian, “What Standard of Care Should Govern the World’s Shortest Editorials?: An Analysis of Bond Rating Agency Liability” (1990) 75 *Cornell L. Rev.* 411 at 413; Lawrence J. White, “The Credit Rating Industry: An Industrial Organization Analysis” in Richard M. Levich, Giovanni Majnoni & Carmen M. Reinhart, eds., *Ratings, Rating Agencies and the Global Financial System* (Boston: Kluwer, 2002) at 43.

<sup>11</sup> Arturo Estrella *et al.*, *Credit Ratings and Complimentary Sources of Credit Quality Information* (No. 3 - August 2000) [unpublished, archived at Basel Committee on Banking Supervision Working Papers] at 11, online: Bank for International Settlements <[http://www.bis.org/publ/bcbs\\_wp3.pdf](http://www.bis.org/publ/bcbs_wp3.pdf)>.

<sup>12</sup> Husisian, *supra* note 10 at 415-419; Rhodes, *supra* note 9 at 294-295; White, *supra* note 10, p. 43.

<sup>13</sup> Estrella, *supra* note 11 at 11.

to society because it most likely duplicates the fundamental questions pertaining to creditworthiness.<sup>14</sup> Furthermore, the willingness of institutional investors to assess the creditworthiness of issuers could be hindered by a public good problem.

The information asymmetry between issuers and investors is troublesome. If left unchecked, it can lead to an adverse selection problem in that the debt of issuers with good credit quality will be undervalued, thereby undermining the viability of the market.<sup>15</sup> In such an environment, issuers have an incentive to disclose their credit quality to investors in order to receive the highest possible price for their issues. Signaling theory suggests that issuers that have good credit quality can communicate this information to investors and receive higher market valuation, through actions that issuers of lower credit quality find too costly to reproduce.<sup>16</sup> One possibility would be for issuers with high credit quality to underprice their issues in order to differentiate themselves from low credit quality issuers.<sup>17</sup> However, this option would not be optimal, as it would raise the cost of capital for issuers.<sup>18</sup> A more effective method would be for issuers to use outside specialists acting as information intermediaries to highlight the superior credit quality of their debt issues.<sup>19</sup>

CRA's acquire and process information with the purpose of ascertaining credit quality. They research and review information from a variety of sources. Through their activities, they can make credit assessments at a lower cost than individual investors, since analysts who have greater expertise in credit rating undertake the research and review. Indeed, their expertise enables them to gather and analyze information more cost-effectively. The economies of scale associated with research and analysis further reduces information costs.<sup>20</sup> Moreover, CRA's can disseminate information rapidly to the market, thereby improving the timeliness of adjustments in prices. Finally, CRA's eliminate the redundant and therefore wasteful efforts of investors individually engaging in research activities.

More importantly, they act as certifying agents by offering their reputation to supplement that of the issuer as a guarantee of quality.<sup>21</sup> For prospective investors to

<sup>14</sup> See Rhodes, *supra* note 9 at 295.

<sup>15</sup> See generally George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism" (1970) 84 *Quarterly Journal of Economics* 488.

<sup>16</sup> See generally Hayne E. Leland & David H. Pyle, "Informational Asymmetries, Financial Structure, and Financial Intermediation" (1977) 32 *Journal of Finance* 371.

<sup>17</sup> *IOSCO Report*, *supra* note 4 at 3; See generally Franklin Allen & Gerald R. Faulhaber, "Signaling by Underpricing in the IPO Market" (1989) 23 *Journal of Financial Economics* 303.

<sup>18</sup> See W.K.H. Fung & Andrew Rudd, "Pricing New Corporate Bond Issues: An Analysis of Issue Cost and Seasoning Effects" 41 *Journal of Finance* 633 at 642 (study finds no clear evidence of underpricing).

<sup>19</sup> See Ronald J. Gilson & Reinier H. Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 *Va. L. Rev.* 549 at 604. See generally Stephen J. Choi, "Market Lessons for Gatekeepers" (1998) 92 *Nw. U.L. Rev.* 916 [Choi, "Gatekeepers"].

<sup>20</sup> See Gilson & Kraakman, *ibid.* at 601.

<sup>21</sup> Partnoy, "Siskel and Ebert", *supra* note 3 at 632.

be convinced of the accuracy of certification, the signal conveyed by CRAs must be credible itself.<sup>22</sup> This requires that three conditions be met.<sup>23</sup> First, the certifying agent must have reputational capital at stake, which would be adversely and materially affected by incorrectly certifying as accurately priced an issue that was actually overvalued. Second, the value of the agent's reputational capital must be greater than the gains to be made from false certification. Third, it must be costly for issuers to purchase the services of the certifying agents, "and this cost must be an increasing function of the scope and potential importance of the information asymmetry ..."<sup>24</sup>

Actually, CRAs probably meet these three criteria.<sup>25</sup> Rating agencies have reputational capital at stake when they issue ratings. They would likely suffer a greater loss from falsely certifying the quality of an issue than they would gain in fees. Finally, the production of ratings is costly.

### **B. An Overview of the Rating Agency Industry**

CRAs are pervasive institutions.<sup>26</sup> The Basel Committee on Banking Supervision estimated that there were over 130 agencies worldwide, with about thirty of them playing a prominent role in G10 countries.<sup>27</sup> Rating agencies may operate at a national, regional, or even global scale. Some provide ratings, solicited or unsolicited, on a limited number of issuers while others have the capability of rating all issuers in a given marketplace using statistical models. Ratings can focus on specific fixed-income securities, including complex financial instruments issued in structured finance, as well as on issuers, such as corporations, municipalities, and governments. Aside from providing ratings, CRAs also offer ancillary services.<sup>28</sup> These services include rating assessment services, whereby they provide an evaluation of the impact of contemplated corporate action on an issuer's rating. Other services include risk management and consulting services designed to assist financial institutions and other corporations in their management of credit and operational risk.

Three of the largest CRAs operating on a global scale are based in the United States. They are Moody's, Standard & Poor's ("S&P"), and Fitch. These three U.S.

---

<sup>22</sup> See Gilson & Kraakman, *supra* note 19 at 605; Choi, "Gatekeepers", *supra* note 19 at 934ff; L. Paul Hsueh & David S. Kidwell, "Bond Ratings: Are Two Better Than One?" (1988) 17:1 *Financial Management* 46 at 47.

<sup>23</sup> Gilson & Kraakman, *ibid.* at 613-21. In the context of investment bankers and venture capitalists, see Randolph P. Beatty & Jay R. Ritter, "Investment Banking, Reputation, and the Underpricing of Initial Public Offerings" (1986) 15 *Journal of Financial Economics* 213 at 217; William L. Megginson & Kathleen A. Weiss, "Venture Capitalist Certification in Initial Public Offerings" (1991) 46 *Journal of Finance* 879 at 881.

<sup>24</sup> Megginson & Weiss, *ibid.*

<sup>25</sup> See Husisian, *supra* note 10 at 426; Rhodes, *supra* note 9 at 295-96; *IOSCO Report*, *supra* note 4 at 3. For a critical view, see Partnoy, "Siskel and Ebert", *supra* note 3 at 703.

<sup>26</sup> Sinclair, *supra* note 1 at 22-30.

<sup>27</sup> White, *supra* note 10 at 44, n. 18.

<sup>28</sup> *IOSCO Report*, *supra* note 4 at 4; *Report on the Role and Function of CRAs*, *supra* note 4 at 42.



rating agencies, which also operate in Canada, are well known, and their activities have been amply chronicled.<sup>29</sup> In Canada, there are two major Canadian CRAs: Dominion Bond Rating Services (“DBRS”) and Canadian Bond Rating Services (“CBRS”), which has recently been purchased by Standard & Poor’s.

Traditionally, CRAs earned their revenues from subscriber fees paid by investors.<sup>30</sup> In the early 1970s, CRAs changed their business model and started charging issuers for their rating services.<sup>31</sup> Nowadays, the larger CRAs derive most of their revenues from the fees charged to issuers.<sup>32</sup>

All of the most important CRAs organize the rating process around similar procedures and mechanisms.<sup>33</sup> From a structural perspective, CRAs establish a rating committee to initiate, withdraw or review a rating. A rating committee is generally formed *ad hoc* and is composed of a lead analyst, managing directors, and junior analytical staff.

The rating process begins with a request by an issuer or its underwriter prior to the offering. The CRA then assigns a lead analyst to that issuer who conducts a preliminary analysis to prepare the rating. The analyst gathers information from issuer and non-issuer sources in order to gain a better understanding of the firm and its environment. Meetings are also held with senior management or government officials. The analyst then submits a report to the rating committee, which proposes a recommendation on the creditworthiness of the issuer or the securities. After discussion, the rating committee issues the credit rating.

Prior to announcing the rating, the CRA notifies the issuer allowing the latter to review the press release for factual verification and to ensure that no confidential information is disclosed. Where it disagrees with the rating, the issuer may appeal the decision by providing new and important information or by pointing out the rating’s reliance on incorrect information or dubious sources.

Lastly, the CRA issues a press release that contains the rating as well as the rationale justifying it. Subsequent to the issue, the rating agency monitors the issuer and its securities by reviewing corporate filings, monitoring industry trends, and maintaining contact with corporate management. When necessary, the CRA will put the issuer on a “watch list” to indicate that it is considering reviewing the rating issued.

---

<sup>29</sup> See Sinclair, *supra* note 1 at 27-30; Roy C. Smith & Ingo Walter, “Rating Agencies: Is There an Agency Issue?” in Richard M. Levich, Giovanni Majnoni & Carmen M. Reinhart, *supra* note 10 at 293-305.

<sup>30</sup> Rhodes, *supra* note 9 at 308-309; Claire A. Hill, “Regulating the Rating Agencies” (2004) 82 Wash. U.L.Q. 43 at 50 [Hill, “Regulating”]; White, *supra* note 10 at 47.

<sup>31</sup> White, *ibid.*

<sup>32</sup> See Estrella, *supra* note 11 at 25; Smith & Walter, *supra* note 29 at 292.

<sup>33</sup> The following discussion is based on Rhodes, *supra* note 9 at 309-316; *IOSCO Report*, *supra* note 4 at 5; Sinclair, *supra* note 1 at 30-42; *Report on the Role and Function of CRAs*, *supra* note 4 at 25-27.

### C. Current Regulation of Ratings and Credit Rating Agencies

In Canada, many federal and provincial regulatory schemes refer to ratings issued by CRAs. In a nutshell, the regulatory regimes rely on such ratings to distinguish investment-grade from speculative securities. For instance, the distinction between investment-grade and speculative securities serves in prudential regulation of the banking and investment dealing industries.<sup>34</sup> It is also used to identify securities in which certain types of institutional investors can invest without prior authorization. In securities regulation, issuers of investment-grade securities benefit from particular exemptions designed to reduce the regulatory burden to reflect the lower level of risk of their securities.<sup>35</sup>

Despite the rather broad use of ratings, there is no principled approach with respect to CRAs. In fact, the organization and activities of CRAs are not regulated per se. Whereas regulatory regimes only recognize ratings issued by “approved” or “recognized” rating agencies, these expressions are only defined through a rudimentary listing of large CRAs.<sup>36</sup>

In the United States, regulatory schemes use ratings for similar purposes.<sup>37</sup> Since 1975, such regulations increasingly require that ratings be issued from a nationally recognized statistical rating organization (“NRSRO”) designated by the SEC.<sup>38</sup> Thus, rating agencies that do not have NRSRO status are barred from a significant segment of the market.<sup>39</sup> Despite its importance, “the term NRSRO has not been officially defined, nor have criteria for NRSRO designation been formally adopted.”<sup>40</sup> Through the no-action letter process, the SEC staff developed a number of criteria that it considers pertinent to NRSRO designation.<sup>41</sup> Among those criteria, the most important is that the applicant must be “‘nationally recognized’ in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings.”<sup>42</sup> According to experts, the weight attributed to this factor creates a Catch-22

---

<sup>34</sup> See e.g. *Money Market Mutual Fund Conditions Regulations*, S.O.R./2001-475, ss. 1.1-1.2; Investment Dealers Association, *Rule Book*, ss. 100.4E.f-100.4E.g. online: Investment Dealers Association <[http://www.ida.ca/Files/BulletinsNotices/RuleBook/RuleBook\\_en.pdf](http://www.ida.ca/Files/BulletinsNotices/RuleBook/RuleBook_en.pdf)>; O. Reg. 157/03, ss. 3.1, 4.5, 6, online: Canadian Legal Information Institute <<http://www.canlii.org/on/laws/regu/2003r.157/20051114/whole.html>>.

<sup>35</sup> See *Short Form Prospectus Distributions*, O.S.C., NI 44-101, 28 O.S.C. Bull. 10385 (23 December 2005), online: Ontario Securities Commission <[http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part4/rule\\_20051223\\_44-101\\_sfpd.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part4/rule_20051223_44-101_sfpd.pdf)>.

<sup>36</sup> Regulatory regimes typically refer to Canadian Bond Rating Services, Dominion Bond Rating Services, Moody’s, Standard & Poor’s, Fitch, Duff & Phelps, and Thomson BankWatch.

<sup>37</sup> See *Report on the Role and Function of CRAs*, *supra* note 4 at 6-8.

<sup>38</sup> Cantor & Packer, *supra* note 1 at 18-19.

<sup>39</sup> See White, *supra* note 10 at 46; Frank Partnoy, “The Paradox of Credit Ratings” in Richard M. Levich, Giovanni Majnoni & Carmen M. Reinhart, *supra* note 10 at 72-78 [Partnoy, “Paradox”].

<sup>40</sup> Hill, “Regulating”, *supra* note 30 at 55 [footnotes omitted].

<sup>41</sup> See *Report on the Role and Function of CRAs*, *supra* note 4 at 9.

<sup>42</sup> *Ibid.*

problem: “an agency has to be nationally recognized to be an NRSRO but has to be an NRSRO to become nationally recognized.”<sup>43</sup> This problem is exacerbated by the relative lack of formality and transparency of the recognition process.<sup>44</sup> In sum, the current framework clearly favours existing rating agencies that are already recognized as NRSROs.<sup>45</sup>

## II. Concerns Over Credit Rating Agencies’ Accountability

Credit rating agencies provide intermediation services to investors and issuers. As intermediaries, CRAs wield influential power over both issuers and investors.<sup>46</sup> Through their activities they influence the conditions under which issuers will have access to debt markets, the conditions of their relationships with lenders, and the structure of their transactions. They can also affect investors’ portfolio decisions. In a perfectly functioning market, the fact that CRAs have such significant power would not be a concern since they would be accountable to both issuers and investors. The real world departs from this ideal in that market failures may lead to a divergence between, on the one hand, the interests of CRAs, and on the other hand, the interests of issuers and investors.

### A. Potential Failures in the Credit Rating Market

#### 1. Sources of Market Failures

##### a. Imperfect Competition

The credit rating industry is highly concentrated. At the international level, the IOSCO reports that Moody’s, S&P, and Fitch dominate the credit rating business.<sup>47</sup> These three agencies are also the dominant players in the U.S.<sup>48</sup> In Canada, the rating industry is also concentrated. The major rating agencies are DBRS and CBRS. American CRAs also provide ratings for Canadian issuers, especially when their securities are sold in the U.S.

---

<sup>43</sup> Hill, “Regulating”, *supra* note 30 at 55.

<sup>44</sup> See Rhodes, *supra* note 9 at 298-99 and 323-29.

<sup>45</sup> Cantor & Packer, *supra* note 1 at 18; Partnoy, “Paradox”, *supra* note 39 at 74.

<sup>46</sup> See Dieter Kerwer, “Holding Global Regulators Accountable: The Case of Credit Rating Agencies” (Working Paper 11, School of Public Policy, University College London, December 2004) at 15; T.J. Sinclair, *supra* note 1 at 22-30.

<sup>47</sup> IOSCO Report, *supra* note 4 at 8; Smith & Walter, *supra* note 29 at 294-97.

<sup>48</sup> White, *supra* note 10 at 45; Hill, “Regulating”, *supra* note 30 at 44. DBRS has been recognized as an NRSRO in the U.S. in 2003.

Although it is beyond the scope of this study to offer a detailed assessment of the level of competition in the credit rating industry, it is worth emphasizing the two principal barriers to entry that contribute to market concentration.

The first barrier stems from the existing regulatory framework. In the U.S., it is linked to the regulatory use of the NRSRO concept.<sup>49</sup> As mentioned above, issuers have an added incentive to obtain ratings from agencies that have NRSRO status. An indirect implication is that new entrants are prevented from acting as raters for a significant number of issuers. This, in turn, bars emerging agencies from attaining a level of business whose scope will be sufficiently broad to warrant NRSRO recognition.

An NRSRO designation may also indirectly affect the Canadian credit rating industry because of the sheer importance of the U.S. market. Canadian corporations rely significantly on U.S. bond markets to obtain debt financing.<sup>50</sup> Given the importance of the U.S. market, issuers will prefer rating agencies that have NRSRO status in order for their debt-instruments to be eligible for purchase by institutional investors in the U.S.<sup>51</sup> In other words, a rating agency that does not have NRSRO status will be disadvantaged in the Canadian market as well.

Canadian regulations impose barriers to entry of their own, by referring to the ratings issued by large CRAs that have the status of “recognized rating organization”. To develop their business, new agencies need to be recognized by securities commissions. Recognition is made problematic by the complexity of the criteria and processes on which commissions base their decision. Furthermore, once recognition is granted, regulatory instruments need to be amended so as to include the new CRAs in their list of recognized rating organizations.

The second barrier to entry stems from the market itself, and is based on the economies of scale and scope, as well as on standardizations that are present in the rating industry.<sup>52</sup> The importance of this market-related barrier to entry would explain why there were very few rating agencies in the U.S. even before the introduction of NRSRO regulation in 1975.<sup>53</sup> Likewise, the importance of this second barrier to entry could explain the scarcity of CRAs in Canada where the regulatory framework is not as restrictive as in the U.S.

---

<sup>49</sup> See Partnoy, “Paradox”, *supra* note 39 at 74; *Report on the Role and Function of CRAs*, *supra* note 4 at 36-40; White, *ibid.* at 46.

<sup>50</sup> Walter Engert & Charles Freedman, “Financial Developments in Canada: Past Trends and Future Challenges” (2003) Summer, Bank Can. Rev. 3 at 9, online: Bank of Canada <<http://www.bankofcanada.ca/en/review/summer03/engerte.pdf>>.

<sup>51</sup> See Rhodes, *supra* note 9 at 341-42; Sinclair, *supra* note 1 at 44-45; *The Multijurisdictional Disclosure System*, O.S.C., NI 71-101 (6 november 1998), online: Ontario Securities Commission <[http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part7/rule\\_19981106\\_71-101ni\\_cpfinal.jsp](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part7/rule_19981106_71-101ni_cpfinal.jsp)>.

<sup>52</sup> White, *supra* note 10 at 46. See also *IOSCO Report*, *supra* note 4 at 9.

<sup>53</sup> White, *ibid.*

The high concentration characterizing the credit rating industry gives rise to two potential problems. First, the dominant CRAs may be tempted to engage in anti-competitive behaviour to restrain entry into the market and maintain their position. Second, they may forgo the quality of the services they provide.<sup>54</sup> The existence and importance of both of these problems is discussed in more detail further below.

### *b. Agency Problems Affecting Credit Rating Agencies*

Credit rating agencies act as conduits between the issuers they rate and investors.<sup>55</sup> Intermediation leads CRAs to act on behalf of both issuers and investors. From an economic perspective, the relationship that exists between a rating agency and issuers or investors can thus be qualified as being one of agency.<sup>56</sup> The interaction between agents and their principals gives rise to potential agency problems.<sup>57</sup>

In the case of CRAs, a first agency problem relates to the investors-CRAs axis.<sup>58</sup> Under the current business model, CRAs are paid by issuers to provide ratings. Thus, the dominant CRAs receive most of their revenue from the issuers that they rate. The practice of issuers paying for their own ratings creates a potential conflict of interests for CRAs.<sup>59</sup> Under such circumstances, agencies may be tempted to downplay the credit risk of issuers and to inflate their ratings in order to retain their business. The practice of charging fees based on the size of offerings also renders CRAs more vulnerable to pressure by larger issuers.

The second problem relates to the issuers-CRAs axis. The development of consulting services by CRAs creates another source of potential conflicts of interests. The rating decisions may be influenced by whether or not an issuer purchases additional services offered by a CRA.<sup>60</sup> Moreover, issuers may feel the need to subscribe to such services simply “out of fear that their failure to do so could adversely impact their credit rating (or, conversely, with the expectation that purchasing these services could help their credit rating).”<sup>61</sup>

---

<sup>54</sup> Robert Baldwin & Martin Cave, *Understanding Regulation: Theory, Strategy, and Practice* (Oxford: Oxford University Press, 1999) at 251; Partnoy, “Siskel and Ebert”, *supra* note 3 at 686; Jean Tirole, *The Theory of Industrial Organization* (Cambridge, M.A.: MIT Press, 1988) at 105-115.

<sup>55</sup> See generally Daniel F. Spulber, “Market Microstructure and Intermediation” (1996) 10:3 *Journal of Economic Perspectives* 135 at 147-48.

<sup>56</sup> Smith & Walter, *supra* note 29 at 290. See also Jill E. Fisch & Hillary A. Sale, “The Securities Analyst as Agent: Rethinking the Regulation of Analysts” (2003) 88 *Iowa L. Rev.* 1035 at 1080.

<sup>57</sup> See generally Michael C. Jensen & William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure” (1976) 3 *Journal of Financial Economics* 305.

<sup>58</sup> See Sinclair, *supra* note 1 at 150-51.

<sup>59</sup> *IOSCO Report*, *supra* note 4 at 10-11; *Report on the Role and Function of CRAs*, *supra* note 4 at 41.

<sup>60</sup> Hill, “Regulating”, *supra* note 30 at 51.

<sup>61</sup> *Report on the Role and Function of CRAs*, *supra* note 4 at 43.

One final agency problem exists that may effect both issuers and investors, in that although the larger CRAs are compensated primarily by issuers, they continue to offer subscriptions to their information services. Subscribers have access to substantial information on ratings, as well as direct access to analysts. Although they do not gain access to information about ratings or rating rationales before it is made available to the investing public, subscribers may have preferential access to material information about issuers and credit ratings.<sup>62</sup> Preferential subscriber access to information is made even more problematic by the special treatment CRAs enjoy under both Regulation FD in the U.S. and Rule 51-201 in Canada. Communications between issuers and CRAs are exempt from insider trading restrictions. Likewise, these communications are exempt from selective disclosure prohibitions.<sup>63</sup> Because of these exemptions, CRAs are permitted access to non-public information to conduct their analysis.

Some contend that allowing issuers to convey non-public information to CRAs contributes to the informational efficiency of the market.<sup>64</sup> Ratings can be viewed as a mechanism through which issuers communicate inside information to bondholders without disclosing its substance. For instance, issuers can use ratings to transmit confidential information, which if disclosed, could compromise the firms' competitive advantage and reduce their market value.<sup>65</sup>

Still, critics stress that CRAs' access to non-public information creates three specific problems.<sup>66</sup> First, CRAs may provide their subscribers with non-public material information, which threatens to destabilize the level playing field upon which investors should trade. Second, rating decisions may be accompanied by greater market volatility as investors speculate as to whether or not non-public information influenced the analysis. Third and finally, rating agency analysts may trade on inside information that is the property of issuers.

These three agency problems are exacerbated by the complexity of the CRAs' methodologies and processes.<sup>67</sup> During hearings held by the SEC, commentators have expressed an interest for more detailed information regarding assumptions underlying the ratings, the ratings criteria, the lists of credit ratings under review, as well as the information and documents on which rating decisions rely. According to these observers, a more transparent approach would reduce the uncertainty and market

---

<sup>62</sup> *Ibid.* at 35.

<sup>63</sup> See *Disclosure Standards*, O.S.C., NP 51-201, 25 O.S.C. Bull. 4492 (12 July 2002), ss. 3.3(2), 3.3(7), online: Ontario Securities Commission <[http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/pol\\_20020712\\_51-201.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/pol_20020712_51-201.pdf)>.

<sup>64</sup> Louis H. Ederington, Jess B. Yawitz & Brian E. Roberts, "The Informational Content of Bond Ratings" (1987) 10 *Journal of Financial Research* 211 at 212.

<sup>65</sup> See Edmund W. Kitch, "The Theory and Practice of Securities Disclosure" (1995) 61 *Brook. L. Rev.* 763 at 848-55.

<sup>66</sup> *IOSCO Report*, *supra* note 4 at 11-14; *Report on the Role and Function of CRAs*, *supra* note 4, pp. 35-36.

<sup>67</sup> *Report on the Role and Function of CRAs*, *ibid.* at 35-36.

volatility that accompany rating changes. Investors would speculate less with respect to rating changes if they better understood what prompted them.

## 2. A Look at the Empirical Evidence Surrounding Market Failures

### a. *The Value of Credit Ratings*

In general, ratings provided by CRAs elicit four types of criticism: (1) the reliability of ratings; (2) the timeliness of rating changes; (3) the CRAs limited success in properly assessing and accounting for bond covenants in their ratings; and, (4) finally and more fundamentally, the relevance of ratings.

#### i. The Reliability of Ratings

Ratings are an evaluation of the creditworthiness of issuers. Following the recent U.S. scandals, commentators have criticized both the performance of CRAs and the reliability of their ratings.<sup>68</sup> Specifically, they questioned whether rating agencies' analysts conduct sufficiently thorough analyses of the various issuers whose debt they rate. They also raised concerns regarding the training and qualifications of these analysts. Others have cast doubt on whether CRAs sufficiently monitor and review issuers' financials, specifying that they too often take the word of issuers' officials rather than seek answers themselves through further probing.

While such criticism is based primarily on anecdotal evidence, a glance at the existing empirical evidence yields a more nuanced assessment of credit ratings' reliability. A good starting point is to examine the credit rating's own track record. Ratings are probabilistic statements of the likelihood of issuer default. Therefore, a basic approach to evaluate the reliability of ratings is to compare them with actual default statistics. Several studies undertaking such a comparison have found a high correlation between credit quality as determined by the rating and default rates.<sup>69</sup>

Another factor that is deemed to be relevant to assessing the success of ratings is their durability. Some contend that to the extent that they have strong predictive value, ratings should be more stable and change less frequently. In this respect, a study conducted by Standard & Poors has shown that ratings were rather stable for

---

<sup>68</sup> See *Report on the Role and Function of CRAs*, *ibid.* at 31-32; *Watchdogs Report*, *supra* note 4 at 115-25; Claire A. Hill, "Rating Agencies Behaving Badly: The Case of Enron" (2003) 35 Conn. L. Rev. 1145; Sinclair, *supra* note 1 at 149-73.

<sup>69</sup> See Charles Adams, Donald J. Mathieson & Garry Schinasi, The International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues* (International Monetary Fund, September 1999) at 137, online: <<http://www.imf.org/external/pubs/ft/icm/1999>>; Cantor & Packer, *supra* note 1 at 19-22; Louis H. Ederington & Jess B. Yawitz, "The Bond Rating Process" in Edward I. Altman, ed., *Handbook of Financial Markets and Institutions*, 6th ed. (New York: John Wiley & Sons, 1987) at 23-16 to 23-17.

investment grade issues.<sup>70</sup> The significance of this criterion should not be overstated. On the theoretical side, it is not clear why durability is a positive attribute of ratings. The timeliness of rating changes, appears more important. On the empirical side, the results of the S&P study may not be surprising given that investment grade issues concern securities of corporations with strong fundamentals.

A final measure of reliability concerns absolute risk. As Cantor and Packer note, “ratings ought to provide a reliable guide to absolute credit risk.”<sup>71</sup> In this respect, studies indicate that ratings have been less reliable as indicators of credit risk. It appears that “default probabilities associated with their specific letter ratings have drifted over time.”<sup>72</sup>

## ii. The Timeliness of Rating Changes

CRA's maintain surveillance of the issuer or its securities following the rating through contact with management and access to publicly disclosed information. The ratings are updated periodically, or on the receipt of material information. The updated analyses are conducted less thoroughly than at issuance.

Rating agencies have been severely criticized for their performance in the continual monitoring of assigned ratings. Many have commented on the lethargy of CRA's when it came to changing their ratings, particularly downgrading.<sup>73</sup> Since the events that spurred such criticism have been amply chronicled, two anecdotal examples will suffice. CRA's maintained Enron's credit rating at above investment grade as late as November 28, 2001, only a few days before it filed for bankruptcy.<sup>74</sup> More recently, agencies were criticized for keeping the ratings for General Motors and Ford just above investment grade at a time where the market traded the bonds of those corporations “at spreads equivalent to junk status.”<sup>75</sup>

The anecdotal evidence concerning rating changes questions the contribution of CRA's to the informational efficiency of the market. This suggests that CRA's do not invest sufficient effort in monitoring ratings once they are assigned. Thus, the agencies lag behind the market when it comes to reviewing the creditworthiness of issuers. When a rating change occurs, the market has already accounted for the information underlying the change.

---

<sup>70</sup> Leo Brand & Reza Bahar, “Corporate Defaults : Will Things Get Worse Before They Get Better?” *Standard and Poor's CreditWeek* (31 January 2001) 15, online: Standard & Poor's Japan <<http://standardandpoors.co.jp/spf/pdf/fixedincome/default%20study%20creditweek.pdf>>; Schwarcz, *supra* note 2 at 13-14; Adams, Mathieson & Schinasi, *ibid.* at 139.

<sup>71</sup> Cantor & Packer, *supra* note 1 at 19.

<sup>72</sup> *Ibid.*

<sup>73</sup> For an overview of the salient cases where CRA's did not “get it right”, see Sinclair, *supra* note 1 at 156-72.

<sup>74</sup> *Watchdogs Report*, *supra* note 4 at 108-113. Enron filed for bankruptcy on 2 December 2001.

<sup>75</sup> “Who rates the raters?” *The Economist* (26 March 2005) 67 at 69.



Although the anecdotal evidence reveals potentially troubling shortcomings, it should not be taken as conclusive in light of empirical studies. Early studies have found that changes in ratings lagged the market by an average of several months. More recent studies show that downgrades do in fact provide new information to market participants, since negative returns are observed in equity markets in response to them.<sup>76</sup> Likewise, rating downgrades of asset-backed securities are accompanied by negative returns and wider spreads.<sup>77</sup> These results indicate that rating changes, particularly downgrades, do not systematically lag the market. This implies that the monitoring of ratings by CRAs is not inherently defective and can provide new information to investors.

### iii. The Relevance of Ratings

According to Professor Partnoy, ratings have virtually no informational content. This assertion is justified by the fact that CRAs do not have the expertise nor the resources to generate information of any real value to the market.<sup>78</sup> His opinion is corroborated by the existence of empirical studies and anecdotal evidence calling the accuracy of ratings into question.<sup>79</sup>

For Partnoy, ratings serve primarily to enable favourable regulatory treatment for issuers. According to this “regulatory license view”, credit ratings are valuable because they determine the substantive effect of legal rules: “If the applicable regulation imposes costs, and a favorable rating eliminates or reduces those costs, then rating agencies will sell regulatory licenses to enable issuers and investors to reduce their costs.”<sup>80</sup> In the U.S., it is the use of NRSRO ratings in various regulations that has led to the emergence of this licensing role for rating agencies.<sup>81</sup>

While it is true that the U.S. regulations have given substantial power to CRAs, Partnoy arguably overstates his case. There are several recent empirical studies indicating that ratings provide new information. In fact, the evidence is serious enough for academics to conclude that “a consensus appears to have been reached that ratings do convey important information to the market ...”<sup>82</sup>

---

<sup>76</sup> Louis H. Ederington & Jeremy Goh, “Bond Rating Agencies and Stock Analysts: Who Knows What When?” (1996) 33 *Journal of Financial and Quantitative Analysis* 569.

<sup>77</sup> John M. Ammer & Nathanael Clinton, “Good News Is No News? The Impact of Credit Rating Changes on the Pricing of Asset-Backed Securities” Federal Reserve Board: International Finance Discussion Paper No. 809 (July 2004), online: The Federal Reserve Board <<http://www.federalreserve.gov/pubs/ifdp/>>.

<sup>78</sup> Partnoy, “Siskel and Ebert”, *supra* note 3 at 651-53.

<sup>79</sup> *Ibid.* at 647, 658-659.

<sup>80</sup> *Ibid.* at 682.

<sup>81</sup> *Ibid.*

<sup>82</sup> Jeff Jewell & Miles Livingston, “A Comparison of Bond Ratings from Moody’s S&P and Fitch IBCA” (1999) 8:4 *Financial Markets, Institutions & Instruments* 1 at 3. See also Soku Byoun & Yoon

More specifically, Professor Hill has convincingly argued that the two rating norms that exist in the U.S., and pursuant to which issuers purchase ratings from Moody's and S&P, cannot be reconciled easily with the regulatory license view.<sup>83</sup> If issuers are merely buying a license when they solicit a rating, why pay more by purchasing two ratings where the regulation only requires one? Furthermore, why does the market react differently to debt instruments carrying two ratings as opposed to only one? As Hill emphasizes, if issuers "were mainly buying the regulatory treatment ... they would not pay much more than was necessary to obtain that treatment".<sup>84</sup>

Thus, it is doubtful that ratings convey absolutely no pertinent information to the market. Rating agencies may have some advantages over investors that enable them to produce valuable information about the fundamentals of issuers. CRAs may also have more time than investors to analyze information about the creditworthiness of issuers. They have also developed specialization in ranking issuers by relative credit quality. Moreover, CRAs may have greater access to information than investors, as issuers may be more inclined to disclose confidential or inside information to them. Besides, ratings may be valuable for investors in that they reflect the issuer's own perception of the creditworthiness of the debt in question.<sup>85</sup> Finally, ratings in themselves may constitute valuable information in that they tend to be self-fulfilling prophecies.<sup>86</sup> A rating conveys information about the entity's borrowing costs as well as the marketability of the debt that is issued.

#### *b. The Potential Conflicts of Interest of Credit Rating Agencies*

Although concerns are frequently expressed concerning the potential conflicts of interest of CRAs, there appears to be little evidence demonstrating the existence of abuses.<sup>87</sup> In the inquiries following Enron's demise, there was no allegation that Moody's decision not to downgrade Enron had been based on improper influence. Following public hearings, the SEC noted that "most hearing participants agreed that, for the most part, the rating agencies had effectively managed" their potential conflicts of interest.<sup>88</sup>

---

S. Shin, "Unsolicited Credit Ratings: Theory and Empirical Analysis" (October 2002), online: Social Science Research Network <<http://ssrn.com/abstract=354125>>.

<sup>83</sup> Hill, "Regulating", *supra* note 30 at 66-67.

<sup>84</sup> *Ibid.* at 66.

<sup>85</sup> See Hseuh & Kidwell, *supra* note 22. See also H. Kent Baker & Sattar A. Mansi, "Assessing Credit Rating Agencies by Bond Issuers and Institutional Investors" (2002) 29 *Journal of Business Finance & Accounting* 1367 at 1376-77.

<sup>86</sup> *Ibid.* at 74. See also *Rating the Raters*, *supra* note 4 at 44 (Jonathan Macey).

<sup>87</sup> White, *supra* note 10 at 50.

<sup>88</sup> *Report on the Role and Function of CRAs*, *supra* note 4 at 23.

At the empirical level, a recent study showed that the conflicts of interests of CRAs do not influence their actions significantly.<sup>89</sup> The study examined one mechanism in particular through which CRAs may act in the interest of issuers, and that is in the context of a rating downgrade. Delaying the negative news conveyed in downgrades can benefit issuers in several ways. If CRAs are conflicted they will attempt to delay downgrades where such changes involve issuers that are important clients. Likewise, conflicted agencies will delay costly downgrades such as those that create “fallen angels”. The study demonstrated that the market anticipated about seventy-five per cent of the downgrades. However, it found no evidence consistent with rating agencies acting in the interests of issuers due to a conflict of interest.<sup>90</sup> On the whole, it does not appear that the potential conflicts of interest to which CRAs are susceptible have materialized into any real misbehaviour on their part.

### c. *Abusive Practices of Credit Rating Agencies*

#### i. The Practice of “Notching”

Notching occurs where a rating agency bases its rating on ratings already assigned by other agencies.<sup>91</sup> CRAs often resort to notching when rating collateral debt obligations (“CDO”). They use this practice to assess those underlying securities that they themselves did not rate. Putting methodological questions aside, notching is not a practice that is problematic per se.

In the U.S., several market participants argue that Moody’s and S&P can employ notching to prevent it from rating certain structured finance markets.<sup>92</sup> According to Fitch, these other agencies frequently engage in “lowering their ratings on, or refusing to rate, securities issued by certain asset pools (e.g., collateralized debt obligations), unless a substantial portion of the assets within those pools were also rated by them.”<sup>93</sup> In other words, Moody’s and S&P used notching as an

---

<sup>89</sup> Daniel M. Covitz & Paul Harrison, *Testing Conflicts of Interest at Bond Rating Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate* (December 2003) [unpublished, archived at the Federal Reserve Board, Washington, D.C.], online: Social Science Research Network <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=512402#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=512402#PaperDownload)>.

<sup>90</sup> See also Alexander W. Butler & Kimberly J. Rodgers, “Relationship Rating : How Do Bond Rating Agencies Process Information?” European Finance Association 2003 Annual Conference Paper No. 491 (27 June 2003), online: Social Science Research Network <<http://ssrn.com/abstract=345860>>.

<sup>91</sup> See Mark Adelson, “NERA Study of Structured Finance Ratings—Market Implications” *Nomura Fixed Income Research* (6 November 2003) at 1, online: Securitization.net <[http://securitization.net/pdf/nomura\\_NERASTudy\\_13nov03.pdf](http://securitization.net/pdf/nomura_NERASTudy_13nov03.pdf)>.

<sup>92</sup> *Report on the Role and Function of CRAs*, *supra* note 4 at 24.

<sup>93</sup> *Ibid.* [footnotes omitted].

anticompetitive strategy.<sup>94</sup> Although these are serious allegations, a recent study conducted by the National Economic Research Associates on the practice of notching proved disappointingly inconclusive, with evidence pointing in both directions with respect to the abusive character of notching.<sup>95</sup>

In Canada, DBRS acknowledges that when rating an issuer, it may rely on the ratings assigned by other agencies.<sup>96</sup> It can adjust such ratings to reflect what it considers to be the credit quality of the issuer. Such adjustment can occur where there is a significant variance between the other major rating agencies. DBRS emphasizes that it “does not believe that automatically ‘notching’ the ratings from other agencies serves any intrinsic analytical purposes.”<sup>97</sup> Nevertheless, notching has yet to elicit any specific criticism from Canadian market and industry participants.

## ii. Unsolicited Ratings

CRA's can issue unsolicited ratings based primarily on public information.<sup>98</sup> Unsolicited ratings are not uncommon but are controversial.<sup>99</sup> Critics stress that CRA's use them as a means of increasing their market share:<sup>100</sup> “By giving borrowers a low, unsolicited rating, the big agencies may force unwilling issuers to pay for their services in the hope of getting a better one.”<sup>101</sup> They point to the case of Moody's who frequently assigned unsolicited ratings of bonds and debt-instruments that were substantially lower than the ratings issued by other agencies.<sup>102</sup> In addition,

---

<sup>94</sup> Greenberg Quinlan Rosner Research Inc., *Most Structured Finance Senior Executives Oppose Notching* (26 March 2002) at 8, online: Greenberg Quinlan Rosner Research Inc. <[http://www.gqrr.com/articles/1616/1408\\_FitchRatings\\_Notching.pdf](http://www.gqrr.com/articles/1616/1408_FitchRatings_Notching.pdf)>.

<sup>95</sup> Andrew Carron *et al.*, National Economic Research Associates, *Credit Ratings for Structured Products: A Review of Analytical Methodologies, Credit Assessment Accuracy, and Issuer Selectivity among the Credit Rating Agencies* (National Economic Research Associates, 6 November 2003), online: National Economic Research Associates <[http://www.nera.com/image/6384\\_es.pdf](http://www.nera.com/image/6384_es.pdf)>.

<sup>96</sup> Mark Adams, Manroop Jhooty & Jireh Wong, Dominion Bond Rating Services, *Collateral Debt Obligations Methodology: Industry Study—Securitization* (Dominion Bond Rating Services, June 2004) at 5, online: Dominion Bond Rating Services <<http://www.dbrs.com/intnlweb/openpdf?fileName=1116945945999.pdf>>.

<sup>97</sup> *Ibid.*

<sup>98</sup> Moody's asserts that issuers do participate to unsolicited ratings. See Moody's Investor Service, Moody's Special Comment, “Designation of Unsolicited Ratings in Which the Issuer Has Not Participated” (November 1999) at 3, online: Moody's <<http://www.moody.com>>; Smith & Walter, *supra* note 29 at 311.

<sup>99</sup> See Hill, “Regulating”, *supra* note 30 at 51-52.

<sup>100</sup> Bottini, *supra* note 3 at 598; *Report on the Role and Function of CRA's*, *supra* note 4 at 24; *IOSCO Report*, *supra* note 4 at 15.

<sup>101</sup> “Credit-Rating Agencies: AAArgh!” *The Economist* (6 April 1996) 80.

<sup>102</sup> Bottini, *supra* note 3 at 598; Sinclair, *supra* note 1 at 152-54; *Jefferson County School District v. Moody's Investor's Servs.*, 988 F. Supp. 1341 (D. Colo. 1997) at para. 14; 25 Media L. Rep. 2351 [*Jefferson*].

unsolicited ratings allegedly distort the pricing mechanism since they tend to be less accurate given the more limited amount of information on which they rely.<sup>103</sup>

Although these allegations are troubling, it remains unclear whether unsolicited ratings amount to an abusive and harmful practice. Aside from the Moody's case, there is little evidence to support the claim that unsolicited ratings are substantially lower than solicited ratings.<sup>104</sup> Interestingly, some have even gone so far as to claim that unsolicited ratings may actually amount to a positive contribution as far as market participants are concerned. First, unsolicited ratings could convey information to the market about credit risk through a signaling effect.<sup>105</sup> According to this view, "bad" firms will choose not to signal their credit quality by refraining from purchasing a rating. The inferior quality of those firms' creditworthiness would then be revealed by the unsolicited ratings. Second, unsolicited ratings may counterbalance the rating shopping bias that can arise when agencies sell favourable ratings to gain or maintain their market share.<sup>106</sup> Finally, unsolicited ratings can also be seen as a mechanism to facilitate potential entry by new competitors.<sup>107</sup> By issuing unsolicited ratings, would-be entrants could build their reputations and gradually establish themselves as credible alternatives to already established CRAs.

These views are paramount in clarifying the true contribution of unsolicited ratings. Still, in the absence of convincing empirical evidence, they cannot be taken to mean that unsolicited ratings actually do have a positive impact on the market. Given the Moody's case, there continues to be a risk that this practice may lead to abuse.

## **B. Legal and Institutional Constraints Influencing the Behaviour of Credit Rating Agencies**

### **1. The Role of Reputation in Shaping the Behaviour of Rating Agencies**

Issuers are only willing to pay for the service of rating agencies if it reduces their cost of capital. Therefore, investors must consider that the agency's opinion diminishes information asymmetries in that it accurately certifies issuers' creditworthiness. The value of this certification depends on the CRA's reputation with respect to accuracy, independence, and integrity.<sup>108</sup> If a CRA has a reputation for erratic or biased analysis, investors will discount the value of the ratings assigned. If

---

<sup>103</sup> Schwarcz, *supra* note 2 at 16-17.

<sup>104</sup> *Ibid.* See Byoun & Shin, *supra* note 82; David M. Ellis, "Different Sides of the Same Story: Investors' and Issuers' Views of Rating Agencies" (1998) 7:4 *Journal of Fixed Income* 35 at 40-41.

<sup>105</sup> Byoun & Shin, *ibid.*

<sup>106</sup> Smith & Walter, *supra* note 29 at 312.

<sup>107</sup> *IOSCO Report*, *supra* note 4 at 15.

<sup>108</sup> See Hill, "Regulating", *supra* note 30 at 50-51; *IOSCO Report*, *ibid.* at 3; Schwarcz, *supra* note 2 at 14; Smith & Walter, *supra* note 29 at 310-11.

investors doubt the accuracy or independence of the ratings of a particular CRA, issuers will seek a more credible agency to signal their creditworthiness.

Because of its value, the reputation of CRAs provides an economic incentive to behave diligently and ethically, even in the absence of regulation. To build and maintain their reputation, CRAs should be expected to put a concerted effort into providing high quality services. In this respect, it is interesting to note that the larger CRAs voluntarily disclose information about their rating methodologies and processes.<sup>109</sup> In its survey of CRAs, the IOSCO Technical Committee remarks that the press release issued when a rating change occurs will usually provide information about the various assumptions underlying the change.<sup>110</sup> The effectiveness of reputation as an incentive is debatable according to Partnoy who notes that the ability of agencies to generate valuable information is hindered by factors such as the high turnover level of their staff, and the relatively modest salaries paid to their analysts.<sup>111</sup>

As far as worries over CRA independence are concerned, since the fees derived from a given issuer form a relatively small portion of their total revenues, CRAs should not be willing to risk damaging their reputation to retain a particular firm as a client.<sup>112</sup> Industry practices indicate that reputation does in fact influence the behaviour of CRAs. The reputational concerns raised by conflicts of interest are reflected in the practices of rating agencies.<sup>113</sup>

Reputational concerns can also curb the potential for abuses stemming from notching and unsolicited ratings.<sup>114</sup> A CRA that disseminates false or misleading information through such practices risks damaging its reputation.<sup>115</sup> The case of Moody's exemplifies this point. After having been chastised for giving low unsolicited ratings, Moody's decided voluntarily to identify such ratings to investors in order to "help to dispel misconceptions, and increase the credibility and utility of

---

<sup>109</sup> See generally *IOSCO Report, ibid.* at 10; Standard & Poors', *Corporate Ratings Criteria 2006*, online: Standard & Poors' <<http://www.standardandpoors.com>>; Standard & Poors', *Rating Services Code of Conduct*, s. 2.1, online: Standard & Poors' <<http://www.standardandpoors.com>>; Dominion Bond Rating Services, "General Overview: Basic Approach to Rating Industrial Companies," online: Dominion Bond Rating Services <<http://www.dbrs.com/intnlweb/openpdf?fileName=1137164013549.pdf>>.

<sup>110</sup> *IOSCO Report, ibid.*

<sup>111</sup> Partnoy, "Paradox", *supra* note 39 at 72.

<sup>112</sup> Smith & Walter, *supra* note 29 at 310-11. See also Stephen J. Choi, "A Framework for the Regulation of Securities Market Intermediaries" (2004) 1 Berkeley Bus. L.J. 45 at 51-52 [Choi, "Framework"].

<sup>113</sup> "Rating Agencies: Exclusion Zone" *The Economic* (8 February 2003) 65: "We may be incompetent but we're not dishonest". Standard and Poors', *Rating Services Code of Conduct*, s. 3.

<sup>114</sup> Schwarcz, *supra* note 2 at 17-18.

<sup>115</sup> See generally U.S., *Hearings on the Current Role and Function of the Credit Rating Agencies in the Operation of the Securities Markets*, Securities and Exchange Commission (Washington, D.C.: United States Government Printing Office, 2002), online: United States Securities and Exchange Commission <<http://www.sec.gov/news/extra/credrate/credrate111502.txt>>.

[its] ratings in the capital markets.”<sup>116</sup> The willingness of CRAs to preserve their reputation may explain why they tend to disclose the unsolicited character of the rating in the press release accompanying it, even though they are not legally required to do so.<sup>117</sup>

Competition is important for the enforcement of reputational sanctions that shape the conduct of CRAs. In a competitive market, information about prices charged, the level of service provided, and performance, tends to be more visible. Furthermore, there are more alternatives with which to compare services offered.

Although the CRA market can be qualified as oligopolistic, there are several mechanisms that facilitate the development of reputational sanctions. First, ratings are publicly disclosed and accessible to investors. Second, other information intermediaries exist, such as financial analysts, in-house rating analysts, and niche players, which also provide investors with data on the creditworthiness of issuers.<sup>118</sup> Third, a CRA may render an unsolicited rating on any issuer that has already been rated by a biased or incompetent agency.<sup>119</sup> Finally, in the U.S. at least, issuers typically seek ratings from the two major CRAs, which then compete to demonstrate their analytical abilities. These mechanisms enable investors to monitor, compare, and assess the performance of rating agencies.

Despite its role, reputation remains a noisy indicator. Investors are only privy to the efforts of rating agencies indirectly through the default rate of the debt-instruments that are rated. Thus, investors may attribute the same reputational effect to debt-instruments that fail for different reasons such as fraud, bad luck or inaccurate rating. In this respect, the fact that rating processes remain opaque further complicates the task for investors.<sup>120</sup> Also, reputation may not work effectively in periods of crisis: “rating agencies can intensify their mutual observations, thus producing similar ratings in order to avoid being the only one wrong.”<sup>121</sup> In addition, the risk that a particular agency should decide to milk its reputation, by lowering quality while continuing to charge premium prices, limits the effectiveness of reputation as a control mechanism over time.<sup>122</sup> Finally, imperfect competition also reduces the effectiveness of reputational pressures. Even if an agency suffers a loss of reputation, new entrants may not be able to displace it because of the barriers to entry. Hence, a loss of reputation may not necessarily translate into a loss of market share for an

---

<sup>116</sup> Moody’s Investors Service, *supra* note 98 at 3; Schwarcz, *supra* note 2 at 17.

<sup>117</sup> Smith & Walter, *supra* note 29 at 311.

<sup>118</sup> See Partnoy, “Siskel and Ebert”, *supra* note 3 at 650-51; Husisian, *supra* note 10 at 425-26; Rhodes, *supra* note 9 at 316.

<sup>119</sup> Hill, “Regulating”, *supra* note 30 at 76.

<sup>120</sup> Partnoy, “Siskel and Ebert”, *supra* note 3 at 651.

<sup>121</sup> Dieter Kerwer, “Standardising as Governance: The Case of Credit Rating Agencies” (Bonn: Max-Planck Institute Collective Goods Preprint No. 2001/3, March 2001) at 25, online: Max Planck Institute for Research on Collective Goods <<http://www.mpp-rdg.mpg.de>> [Kerwer, “Standardising as Governance”].

<sup>122</sup> IOSCO Report, *supra* note 4 at 16.

agency, thereby mitigating the impact of reputational pressures on established agencies.

## 2. Issuer Disclosure

For CRAs to make accurate assessments of the creditworthiness of debt-instruments, they require access to information about issuers at the moment of the offerings as well as subsequently.<sup>123</sup> The primary source of firm-specific information for CRAs is the disclosure documents released by issuers. Agencies may also engage in discussion with the management of issuers to gain additional access to non-public information that is relevant to their analysis. In this respect, communications between issuers and CRAs benefit from special regulatory treatment.<sup>124</sup>

Although issuers are subject to mandatory disclosure provisions, the quality and the timeliness of the information provided are not assured.<sup>125</sup> In the U.S., commentators have remarked before the SEC that several deficiencies exist with respect to issuers' disclosure of short-term credit facilities and ratings triggers in material contracts.<sup>126</sup> Furthermore, mandatory and voluntary disclosure is not always accurate. However, it is not currently a practice of CRAs to verify or audit the information disclosed by issuers. This lack of inquisitiveness on the part of CRAs has been criticized by the U.S. Senate Committee on Governmental Affairs investigating the Enron failure: "their monitoring and review of [Enron's] finances fell far below the careful efforts one would have expected from organizations whose ratings hold so much importance."<sup>127</sup>

To be fair, this behaviour on the part of CRAs may be economically justifiable. Rating agencies cannot investigate issuers on an ongoing basis as thoroughly as they did during the initial rating process since the costs of doing so would be very high.<sup>128</sup> In this respect, it appears reasonable for rating agencies to rely on other third-party

---

<sup>123</sup> *Ibid.* at 12.

<sup>124</sup> See *Securities Act*, R.S.O. 1990, c. S.5, s. 76(2) [*Securities Act*]; *Disclosure Standards*, *supra* note 63, s. 3.3.(2); Borden Ladner Gervais, *Securities Law and Practice*, 3rd ed. (Toronto: Carswell, 1988) at § 18.2.8.

<sup>125</sup> See e.g. Ontario Securities Commission Staff Notice, 51-708, "Continuous Disclosure Review Program Report—August 2002" (August 2002), online: Ontario Securities Commission <[http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/sn\\_20020813\\_51-708.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/sn_20020813_51-708.pdf)>; Ontario Securities Commission, Staff Notice, 52-713, "Report on Staff's Review of Interim Financial Statements and Interim Management's Discussion and Analysis—February 2002" (February 2002), online: Ontario Securities Commission <[http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/sn\\_20020301\\_52-713\\_fin-stat.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/sn_20020301_52-713_fin-stat.pdf)>; Toronto Stock Exchange Committee On Corporate Disclosure, "Toward Improved Disclosure—Interim Report", (1996) 19 O.S.C. Bull. 1 at 40-41.

<sup>126</sup> *Report on the Role and Function of CRAs*, *supra* note 4 at 30.

<sup>127</sup> *Watchdogs Report*, *supra* note 4 at 115.

<sup>128</sup> Hill, "Regulating", *supra* note 30 at 70.



certifying mechanisms to ensure the disclosure of accurate information.<sup>129</sup> Besides, although CRAs may downgrade or withdraw an existing rating where they detect that issuers are not fully transparent and are withholding important information, this sanction has limited effectiveness.<sup>130</sup>

### 3. The Influence of Securities Regulation on the Transparency and Dissemination of Ratings

Securities regulation does not impose any direct obligations on CRAs. Issuers must disclose ratings obtained from CRAs in their prospectus.<sup>131</sup> However, the extent of the mandated disclosure is rather limited as the prospectus need only provide information on the rating obtained, the name of the rating organization, as well as details on the meaning of the rating.<sup>132</sup> In the secondary market, pursuant to National Policy 51-201, a rating change consists primarily of material information and should lead issuers to establish a material change report as well as issue a press release.<sup>133</sup>

This does not mean that CRAs operate in a total regulatory vacuum. It is interesting to note the general remarks formulated by securities regulators in National Policy 51-201 when setting out the contours of the selective disclosure exemptions.<sup>134</sup> The policy states that CRAs benefit from such an exemption since their ratings are either provided confidentially to issuers or disclosed to a wide public audience. According to the policy, the objective of the rating process is to provide a widely available publication of the rating. In contrast, regulators note that securities analysts' reports are primarily aimed at the firms' clients. These remarks suggest that the scope of the disclosure of ratings is a factor that directly influences the regulatory treatment of communications between CRAs and issuers. This treatment also provides an additional incentive for CRAs to publicly disclose and disseminate their ratings.

More specifically, CRAs must respect the provisions of securities regulation that deal with insider trading.<sup>135</sup> When they obtain material non-public information from issuers, CRAs may not communicate or trade on this inside information. This prohibition extends to their analysts and other employees. Besides, as seen below, CRAs are subject to the liability regimes enacted by securities regulation.

---

<sup>129</sup> See Marcel Kahan, "The Qualified Case Against Mandatory Terms in Bonds" (1995) 89 Nw. U.L. Rev. 565 at 590-93.

<sup>130</sup> *IOSCO Report*, *supra* note 4 at 12-13; *Report on the Role and Function of CRAs*, *supra* note 4 at 31-32.

<sup>131</sup> See *Prospectus Disclosure Requirements*, O.S.C., NI 41-101, 23 O.S.C. Bull. (Supp.) 761 (15 December 2000), Item 10.8 [*Information Required in a Prospectus*], online: Ontario Securities Commission <[http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Other/rule\\_20001215\\_general.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Other/rule_20001215_general.pdf)>.

<sup>132</sup> *Ibid.*

<sup>133</sup> *Disclosure Standards*, *supra* note 63, s. 4.3.

<sup>134</sup> *Ibid.*, s. 3.3(7).

<sup>135</sup> *Securities Act*, *supra* note 124, s. 76.

#### 4. The Liability of Credit Rating Agencies

Although CRAs are not specifically regulated, their activities remain subject to the general civil liability regimes that apply to other participants in the securities market. Theoretically, liability can positively influence the accuracy of CRAs' analyses.<sup>136</sup> CRAs can be held liable towards investors for the ratings they disclose where they contain misrepresentations. In the primary market, the rating of debt instruments by a CRA in the context of an offering triggers disclosure obligations for issuers. Issuers must disclose the rating obtained in their prospectus, the name of the rating organization, as well as details on the meaning of the rating.<sup>137</sup> In theory, such disclosure of information about the rating granted should activate the application of the statutory liability regime enacted by securities legislation. However, the liability regime only applies to those persons whose consent has been filed pursuant to a requirement of the regulations. Exceptionally, in the case of ratings, issuers need not obtain the written consent of the rating agency for the disclosure of this information.<sup>138</sup> Therefore, the statutory civil liability regime will not apply to ratings disclosed in the prospectus.

Thus, CRAs are only subject to the general common law (or civil law) liability regime in place in the primary market. The situation is the same in the secondary market where the new statutory civil liability regime does not cover ratings. Since the application of the general liability regimes proves very difficult for investors, liability is not a significant constraint affecting the behaviour of rating agencies in Canada. For different reasons, liability also plays a limited role in disciplining rating agencies operating in the American markets. In the U.S., the publications of CRAs have traditionally been afforded the protection of the First Amendment.<sup>139</sup> CRAs are therefore not liable for negligent misrepresentations. Only if their conduct is reckless can they be held liable for misrepresentations.

#### **C. Summation: Is There an Accountability Gap?**

Given their role in capital markets, CRAs wield power over issuers and investors. As standards of creditworthiness, ratings have a coercive impact on issuers given the regulatory use of ratings. Irrespective of regulation, ratings also affect issuers as they can determine the conditions under which they may access debt markets, the conditions of their relationships with lenders, and the structure of their transactions. For investors, ratings are a screening tool that influences the composition of their portfolios as well as their investment decisions.

However, “despite the fact that rating agencies have become increasingly influential in global financial markets, it is very hard to hold them accountable for

---

<sup>136</sup> Husisian, *supra* note 10 at 430.

<sup>137</sup> See *Information Required in a Prospectus*, *supra* note 131, Item 10.8.

<sup>138</sup> See *ibid.*, s. 13.4(4).

<sup>139</sup> Husisian, *supra* note 10 at 446ff; *Jefferson*, *supra* note 102 at para. 13.

their action[s] ...”<sup>140</sup> This is because the exit and voice options that are available to market participants to hold rating agencies accountable work imperfectly. As for exit, it is difficult for issuers and investors to do away with CRAs given the current regulatory use of ratings. As for voice, the only real existing mechanism appears to be reputation.<sup>141</sup>

In other words, there appears to be an accountability gap, which constitutes an imbalance between the power of CRAs and the possibility of holding them responsible.<sup>142</sup> This accountability gap is worrisome. For CRAs, the accountability gap may affect their credibility in the marketplace.<sup>143</sup> For market participants, it is of particular concern given the role that CRAs play in capital markets: “Investors and markets generally are hurt if they give ratings more credence that is warranted; they also may be hurt by the volatility caused by precipitous upgrading and downgrading.”<sup>144</sup>

### III. Enhancing the Accountability of Credit Rating Agencies: The Role of Regulation

The accountability gap affecting credit rating agencies preoccupies policy makers and regulators. This has led to an active effort to find solutions to bridge the accountability gap. In December 2004, the IOSCO published a *Code of Conduct Fundamentals for Credit Rating Agencies*, which aims to ensure the quality and integrity of ratings.<sup>145</sup> According to the IOSCO, the implementation of the code’s principles should be left to market pressures. In April 2005, the SEC proposed adopting a rule that would clearly define the conditions that an entity must satisfy in order to obtain an NRSRO designation.<sup>146</sup> In Europe, the Committee of European Securities Regulators, which provided counsel to the European Commission regarding possible measures concerning CRAs, remarked that “the IOSCO Code strikes a balance between the different interests of the rating process; those of the agencies themselves, those of the issuers and those of investors.”<sup>147</sup> It favoured the approach of the IOSCO and advised the Commission that the implementation of the Code be left to market pressures for the time being. In a recent speech, Internal Market Commissioner McCreevy indicated that the Commission would follow this

---

<sup>140</sup> Kerwer, “Standardising as Governance”, *supra* note 121 at 3. See also *Watchdogs Report*, *supra* note 4 at 122 (the U.S. Senate Committee Staff concluded that “credit analysts do not view themselves accountable for their actions”).

<sup>141</sup> *CESR’s Technical Advice*, *supra* note 5 at 51.

<sup>142</sup> Kerwer, “Standardising as Governance”, *supra* note 121 at 20. See also David Millon, “Who ‘Caused’ the Enron Debacle?” (2003) 60 Wash. & Lee L. Rev. 309 at 324.

<sup>143</sup> See Clark C. Havighurst, “The Place of Private Accrediting Among the Instruments of Government” (1994) 57:4 Law & Contemp. Probs. 1 at 4.

<sup>144</sup> Hill, “Regulating”, *supra* note 30 at 84.

<sup>145</sup> *IOSCO Code*, *supra* note 5.

<sup>146</sup> *NRSRO Definition*, *supra* note 5.

<sup>147</sup> *CESR’s Technical Advice*, *supra* note 5 at 49.

advice.<sup>148</sup> In light of these initiatives, this part examines which approach of enhancing the accountability of CRAs would best suit the Canadian regulatory framework.

### **A. The Regulation of Credit Rating Agencies: Policy Perspectives**

#### **1. The Goals of Securities Regulation**

Credit rating agencies can be qualified as information intermediaries. By reducing information asymmetries between issuers and investors, they perform a function that contributes to an efficient capital market. Given this function, CRAs are institutions that fall under the scope of securities regulation. Any regulatory effort concerning rating agencies should espouse the twin goals underlying securities regulation: efficiency and investor protection.

##### *a. Market Efficiency*

Securities regulation aims to foster greater market efficiency.<sup>149</sup> Generally speaking, this entails encouraging the most rational allocation of capital resources. First, the goal of market efficiency requires that regulation promote informational efficiency by reducing information asymmetries between issuers and investors. Second, efficiency requires that transaction costs be kept low so as to ensure the continued use of capital markets.

In the context of CRAs, the goal of market efficiency requires that regulation seek to prevent the market failures that can affect rating agencies' activities and processes. Regulation would thus improve the accuracy and credibility of credit ratings, and thereby contribute to the informational efficiency of the market.

At the same time, regulatory interventions should factor in the need to maintain low transaction costs for participants in the market for debt instruments. In this regard, there has been little concern voiced over the level of fees charged by rating agencies in the United States or Canada.<sup>150</sup> Without dismissing the possibility that CRAs may be able to extract supra competitive fees, in the absence of hard data, more attention should be directed towards those costs associated with regulation.

---

<sup>148</sup> "Rating Agencies let off the hook—for now" *EurActiv* (11 April 2005) online: EurActiv.com <<http://www.euractiv.com/Article?tcaturi=tcm:29-137622-16&type=News>>.

<sup>149</sup> *Securities Act*, *supra* note 124, s. 1.1. See David Johnston & Kathleen Doyle Rockwell, *Canadian Securities Regulation*, 3d ed. (Toronto: LexisNexis Butterworths, 2003) at 2-6.

<sup>150</sup> Schwarcz, *supra* note 2 at 12-13.

*b. Investor Protection*

Securities regulation also purports to protect investors from fraud and other forms of exploitation in order to preserve public confidence in the market.<sup>151</sup> To some extent, the goal of investor protection runs opposite to the goal of market efficiency. For this reason, there has been considerable debate about the appropriate emphasis of each of these goals in the context of securities regulation. Without presuming to resolve this debate it seems that investor protection should carry less weight than efficiency when discussing regulatory interventions aimed at credit rating agencies.

The market for corporate bonds tends to be dominated by institutional investors or sophisticated investors.<sup>152</sup> Furthermore, it appears that the ownership of bonds of specific issues is concentrated with a small number of investors owning a high proportion of the bonds of a single issue. These characteristics of the bond market are highly relevant when discussing the goal of investor protection.<sup>153</sup> Institutional investors possess the expertise to analyze the information disclosed by issuers and to verify its accuracy. In this respect, since institutional investors tend to participate in many different offerings, they tend to have significant experience when it comes to analyzing the value of issuers. Institutions also possess the resources to dig deeper when researching issuers, enabling them to uncover undisclosed information that can affect credit risk. In sum, institutional investors are not defenceless in credit markets. They are also not entirely dependent on CRAs to assess debt instruments.<sup>154</sup> Since they can form critical judgments of the ratings in light of their own analysis and research, institutional investors can contribute to moderating the conflicts of interest affecting CRAs.<sup>155</sup>

The dominance of institutional investors in bond markets also carries implications for retail investors. Investors can protect themselves by investing their funds through institutional investors to benefit from the informational advantage that the latter possess. Generally speaking, retail investors can benefit from the efforts of institutional investors, which are instrumental in debt instruments valuation. Thus, retail investors are not defenceless either in credit markets. Therefore, it is doubtful that the goal of investor protection should drive regulatory interventions targeted at

<sup>151</sup> *Securities Act*, *supra* note 124, s. 1.1; See Johnston & Rockwell, *supra* note 149 at 2-4.

<sup>152</sup> See *IOSCO Report*, *supra* note 4 at 4; Bank of Canada, "Submission on the Revised CSA Alternative Trading System ("ATS") Proposal", Legislative Comment at 5, online: Ontario Securities Commission <[http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part2/Comments/21-101/com\\_20000929\\_21-101\\_tnoel-bhamilton.pdf](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part2/Comments/21-101/com_20000929_21-101_tnoel-bhamilton.pdf)>; *Doraldick Investments Ltd. v. Canadian Imperial Bank of Commerce*, [1998] 44 B.L.R. (2d) 192 (Ont. Ct. J.) at para. 34.

<sup>153</sup> See Kahan, *supra* note 129 at 583-86.

<sup>154</sup> Baker & Mansi, *supra* note 85 at 1395, online: Social Science Research Network <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=288683#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=288683#PaperDownload)>.

<sup>155</sup> See Alexander Ljungqvist *et al.*, *Conflicts of Interest in Sell-side Research and The Moderating Role of Institutional Investors* (12 September 2005) [unpublished, archived at Salomon Center, Stern School of Business, New York University], online: Social Science Research Network <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=649684#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649684#PaperDownload)>.

credit rating agencies. Policy should be more concerned with ensuring that the market is efficient.<sup>156</sup>

## 2. The Importance of a Cost-Effective Regulatory Regime

When discussing policy options, it is important to remember that government failures can also exist. It is possible to distinguish two types of government failures.<sup>157</sup> The first arises where the government is guided by the public interest. Even under such circumstances, regulation generates costs that must be taken into account when assessing the utility of government intervention. One category of costs can be qualified as “administrative”. These are generated by the government agency charged with the formulation of the rules and standards of conduct, the monitoring of behaviour and the enforcement of compliance. A second category is the compliance costs borne by market participants. These costs depend on the degree of precision and flexibility of regulation. They are compounded by the lack of harmonization of national regulatory regimes that apply to market participants, such as CRAs, that operate in multiple jurisdictions.

A second type of government failure surfaces where the assumption concerning the competence of government officials and the objective guiding their interventions are relaxed. In the real world, government officials can be incompetent, plagued by informational problems or affected by psychological biases, just as any other market actor. Where this is the case, the costs of regulation will be greater and the benefits smaller. Even more worrisome, government officials may not be guided by the public interest when shaping a regulatory regime. As public choice theorists argue, they may be pursuing the private goals of concentrated interest groups which captured them in one way or another. This may lead to excessive or insufficient regulation.

These two types of failures have undesirable implications when making policy choices. The first is the need to consider that regulation generates costs that may offset any efficiency gains sought. Even where there is a market failure, government intervention may not always yield a superior outcome. Any case for regulatory intervention will thus have to demonstrate not only that a market imperfection exists, but that its impact would be reduced by the proposed policy measure or reform in a cost-effective manner. Thus, the analysis of policy options concerning CRAs should always take cost-effectiveness into consideration.<sup>158</sup> The second implication involves considering that the goal of efficiency may be compromised when private interests groups capture the regulator. Where such capture occurs, the risk that regulation be

---

<sup>156</sup> CESR's *Technical Advice*, *supra* note 5 at 52.

<sup>157</sup> Peter P. Swire, *Markets, Self-Regulation, and Government Enforcement in the Protection of Personal Information* (1999) [unpublished], online: Social Science Research Network <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=11472#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=11472#PaperDownload)>.

<sup>158</sup> See William P. Albrecht *et al.*, “Regulatory Regimes: The Interdependence of Rules and Regulatory Structure” in Andrew W. Lo, ed., *The Industrial Organization and Regulation of the Securities Industry* (Chicago: University of Chicago Press, 1996) at 11.

biased against entry and competition surfaces.<sup>159</sup> In light of this risk, Mayer cautions that “[t]he scope of regulation should therefore be limited to areas where there is a clear case of market failure.”<sup>160</sup>

From this perspective, enhancing the accountability of CRAs requires balancing the failings of both market and regulatory mechanisms. Following the framework proposed by Choi, this involves evaluating the regulatory options in light of market-based incentives that exist to address the various problematic issues affecting CRAs.<sup>161</sup> Thus, “[w]here the market has an incentive to correct for any failings, less interventionist regulation is required.”<sup>162</sup>

## ***B. An Overview of the Current Proposals to Enhance the Accountability of Credit Rating Agencies***

### ***1. The IOSCO Code of Conduct Fundamentals for Credit Rating Agencies***

At the international level, the IOSCO Technical Committee published a statement of principles that “laid out high-level objectives that rating agencies, regulators, issuers and other market participants should strive toward ...”<sup>163</sup> Subsequently, the Committee proposed a Code of Conduct Fundamentals that provides guidelines with respect to those principles. Pursuant to the Code, discretion involving the implementation of the fundamentals is left to CRAs and is subject to market pressures.

#### ***a. The Rating Process***

##### ***i. The Quality of the Rating Process***

The Code sets forth a series of provisions to ensure the quality of the opinions expressed by CRAs. Although the concept of “quality” is not defined, it appears to refer to the accuracy of the ratings. The Code states that CRAs should seek to avoid disclosing analyses or reports that contain misrepresentations as to the general

---

<sup>159</sup> See Luigi Zingales, *The Costs and Benefits of Financial Markets Regulation*, Law Working Paper No. 21/2004 (April 2004) [unpublished, archived at the University of Chicago European Corporate Governance Institute], online: Social Science Research Network <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=536682#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=536682#PaperDownload)>.

<sup>160</sup> Colin Mayer, “The Regulation of Financial Services: Lessons from the U.K. for 1992” in Matthew Bishop, John Kay & Colin Mayer, *The Regulatory Challenge* (Oxford: Oxford University Press, 1995) at 148.

<sup>161</sup> Choi, “Framework”, *supra* note 112 at 71.

<sup>162</sup> *Ibid.*

<sup>163</sup> *IOSCO Code*, *supra* note 5 at 1.

creditworthiness of an issuer or security. To attain this objective, the provisions stress the importance of methodologies and processes, people, and resources.

With respect to methodologies and processes, the Code emphasizes the need for CRAs to conduct a “thorough analysis” of all public and non-public information known and believed to be relevant. CRAs are also encouraged to use “rating methodologies that are rigorous, systematic, and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience.”<sup>164</sup>

Recognizing the central role of analysts, the Code dictates that CRAs should rely on analysts “who, individually or collectively have appropriate knowledge and experience in developing a rating opinion.”<sup>165</sup> The analysts should be grouped in teams to promote continuity and avoid bias in the rating process. Furthermore, the analysts should use the same methodologies established by the CRAs that employ them.

Finally, the Code recommends CRAs ensure that sufficient resources are devoted to ratings in order to “carry out high quality credit assessments.”<sup>166</sup> Any decision to rate or continue rating should be preceded by an assessment of whether adequate personnel possessing sufficient skills sets can be involved to make a proper rating assessment.

#### ii. Monitoring and Updating

The Code provides that CRAs should monitor the ratings on an ongoing basis. To monitor ratings, CRAs should regularly review the issuer’s creditworthiness. They should initiate a review of the rating upon receipt of any information that might reasonably be expected to result in a rating action. Based on the results of such review, CRAs should update the rating in a timely fashion. Where a CRA discontinues rating an issuer or debt instrument, it should make the decision public. If the discontinued rating remains published, the CRA should indicate the date the rating was last updated and the fact that it is no longer being updated.

#### iii. The Integrity of the Rating Process

The Code contains several provisions that purport to reinforce the integrity of the rating process. In general, the Code provides that the CRAs and their employees should comply with applicable laws and regulations, and deal fairly and honestly with issuers, investors, and other market participants. More specifically, the CRAs and their employees should not give issuers any assurances or guarantees of a particular

---

<sup>164</sup> *Ibid.* at 4.

<sup>165</sup> *Ibid.*

<sup>166</sup> *Ibid.*



rating prior to the actual assessment. Furthermore, the Code explicitly states that a CRA's analysts should be held to high standards of integrity.

The Code provides that a CRA should institute policies and procedures that clearly identify a specific person responsible for ensuring compliance with the code of conduct and with applicable laws and regulations. Furthermore, the Code imposes a whistleblowing duty upon every CRA employee to report illegal or unethical conduct.

*b. Credit Rating Agencies Independence and Avoidance of Conflicts of Interest*

*i. General Principles*

The Code urges the CRA and its analysts to use care and professional judgment in order to maintain both the substance and appearance of independence and to promote objectivity. It states that the determination of a rating should be based solely on factors relevant to the credit assessment. The existence or potential existence of a business relationship between CRA and issuer, or the absence of such a relationship, should not affect the rating process. To avoid such a situation, the Code provides that CRAs should separate their credit rating business and CRA analysts from any other business they conduct.

*ii. Procedures and Policies*

CRAs should adopt internal procedures and mechanisms to identify and eliminate, or manage and disclose, any actual or potential conflicts of interest that may affect rating opinions. Where the CRAs elect to manage the conflicts of interest through disclosure, they should ensure that the disclosure of actual or potential conflicts of interests is complete, timely, clear, concise, specific, and figures prominently in the disclosure documents. In either case, the CRAs should disclose these internal procedures and mechanisms to the public.

The Code concedes that certain conflicts of interests cannot be managed effectively. It enjoins CRAs and their staff to refrain from trading securities or derivatives presenting conflicts of interest with their ratings activities. Likewise, the Code states that CRAs should proceed with caution when rating a government issuer that is also involved in the oversight of rating. Specifically, a CRA should ensure that it uses different employees to conduct the rating than those involved in the oversight issues with the government issuer.

The Code also contains specific provisions dealing with compensation of CRAs, which can raise conflict of interest issues. It provides that CRAs should disclose the general nature of their compensation arrangements with issuers and other rated entities. They should also disclose compensation already received from issuers, including compensation which is unrelated to the rating service, making sure to

highlight the proportion of total earnings such compensation represents in comparison to fees received strictly from rating services.

### iii. Analyst and Employee Independence

Pursuant to the Code, the CRA should structure their compensation arrangements in such a way as to eliminate or manage effectively all actual or potential conflicts of interests in order to ensure the independence of its analysts and employees. CRAs should explicitly state and ensure that the employees' and analysts' compensation or evaluation will not depend on the amount of revenue derived from the issuers they rate.

The Code also provides specific prohibitions in order to ensure the independence of analysts and employees. Whenever an analyst becomes involved in a personal relationship that creates the potential for any real or apparent conflicts of interest, the analyst should be required to disclose such a relationship to the appropriate officer of the CRA, in accordance with its compliance policies.

## c. *Credit Rating Agencies' Responsibilities to the Investing Public and to Issuers*

### i. Transparency and Timeliness of Ratings Disclosure

The Code enjoins CRAs to strive for transparency with respect to their ratings and rating processes. It requires that the ratings decisions, or the subsequent decision to discontinue a rating, be dispensed in a timely manner, on a non-selective basis, and free of charge. When issuing a rating, agencies should explain the key elements underlying the rating decision. Furthermore, where feasible and appropriate, CRAs should advise issuers of all critical information and principal considerations upon which rating will be based prior to issuing or revising a rating, in order to afford the issuer the opportunity to provide the CRA with any factual clarifications that will be necessary for it to produce an accurate rating. CRAs should also disclose whether or not ratings are solicited at the request of the issuer, and whether or not the issuer participated in the rating process.

Moreover, CRAs should publicly disclose their policies for distributing ratings and reports. They should also publish sufficient information about their procedures, methodologies and assumptions so that outside parties can understand how the rating was derived. When these procedures, methodologies or assumptions change, the CRAs should publicly disclose all of the modifications.

Finally, the Code requires that CRAs publish sufficient information about the historical default rates of its ratings categories, and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category, as well as see if and how ratings categories have changed. This requirement seeks to promote transparency and enable the market to assess the performance of the ratings by drawing comparisons from ratings issued by different CRAs.

## ii. Treatment of Confidential Information

CRAs should establish procedures and mechanisms to protect the confidential nature of the information it receives from issuers. Unless permitted, the CRA should not disclose confidential information in press releases or in other communications with market participants.

The CRAs should only use the confidential information obtained for purposes relating to their rating activities. Their employees should not share confidential information with employees of any affiliated entities that are not CRAs, nor share such confidential information with colleagues within the CRA unless necessary. In addition, the employees should not selectively disclose any non-public information about rating opinions or future rating actions.

The employees of CRAs should be prohibited from engaging in transactions involving securities when they possess confidential information concerning the issuer of such securities. They should also refrain from using or sharing confidential information for purposes relating to trading securities, or for any other purpose unrelated to the conduct of the CRAs' business.

CRAs should ensure the confidentiality of the information gathered by ensuring that their employees take all reasonable measures to protect it. The agencies should also make sure that their employees familiarize themselves with internal securities trading policies.

## d. Disclosure of the Code of Conduct

The IOSCO Code recommends that CRAs publicly disclose their codes of conduct, making sure to highlight how they measure up to the provisions contained in the IOSCO Code. Thus, CRAs should describe to what extent the provisions of their own codes of conduct are consistent with those of the IOSCO Code. CRAs should also describe how they intend to implement and enforce its code of conduct, as well as disclose any changes to its provisions or implementation on a timely basis.

## 2. The Securities and Exchange Commission's Proposal to Define the Concept of Nationally Recognized Statistical Rating Organization

Following hearings and reports by lawmakers, the SEC conducted its own study on the role and the function of CRAs.<sup>167</sup> It published a Concept Release where it discussed various issues relating to credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes and, if so, which process to

---

<sup>167</sup> *Sarbanes-Oxley Act of 2002*, 15 U.S.C. tit. 7 § 702(b), online: FindLaw <<http://files.findlaw.com/news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf>>; *Report on the Role and Function of CRAs*, *supra* note 4.

use in determining whose credit ratings should be used, and the level of oversight to apply to credit rating agencies.<sup>168</sup> The ensuing discussions generated by the Concept Release led the SEC to propose a rule that would define the conditions that agencies must satisfy in order to obtain an NRSRO designation.<sup>169</sup> In addition to the proposed rule, the SEC is also considering the development of a voluntary framework for oversight of CRAs that would enable it to assess whether the latter continue to meet the NRSRO designation criteria. The development of this framework is necessary because the SEC lacks formal jurisdictional authority over CRAs in this respect.

The rule proposed by the SEC seeks to bring a greater degree of clarity and transparency to the NRSRO designation process, while ensuring that agencies recognized as NRSROs use systematic procedures to address concerns raised by their activities. Specifically, the rule provides that a rating agency must satisfy the three conditions to be designated as an NRSRO, at which point, the NRSRO designation would be approved by the SEC staff through no-action letters as is presently the case.

*a. Issuance of Publicly Available Ratings that Are Current Assessments of the Creditworthiness of Obligors with Respect to Specific Securities*

The organization should issue ratings that are publicly available.<sup>170</sup> The public accessibility criterion would refer only to the rating itself and not to other information such as the rating's rationale. Thus, the organization would continue to benefit from the possibility of offering subscriptions to newsletters providing more details about its ratings.

Ratings publicly disseminated by the organization would have to focus on the creditworthiness of the issuer with respect to specific securities or obligations. This is because the regulatory use of the term NRSRO "primarily relates to credit ratings on specific securities or obligations."<sup>171</sup> It would therefore be insufficient for the organization to only provide ratings on the general creditworthiness of issuers.

Finally, the organization would have to provide ratings that are current, i.e., that reflect its opinion of the creditworthiness of the securities at the time of the rating up until it is amended or withdrawn. In order to meet this requirement, the organization would have to implement and adhere to procedures destined to ensure that ratings are reviewed and updated whenever material changes occur.

---

<sup>168</sup> U.S. Securities and Exchange Commission, Concept Release, 33-8236, "Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws" (10 July 2003), online: United States Securities and Exchange Commission <<http://www.sec.gov/rules/concept/33-8236.htm>>.

<sup>169</sup> *NRSRO Definition*, *supra* note 5.

<sup>170</sup> See *ibid.* at 24-25.

<sup>171</sup> *Ibid.* at 25.

*b. Recognition of Credibility and Reliability by the Financial Markets*

The NRSRO status would continue to be granted to organizations that have a wide recognition in the marketplace. Thus, the definition of NRSRO would contain a requirement whereby the organization would be required to demonstrate that it is generally recognized in the marketplace as an issuer of credible and reliable ratings by the majority of participants that make use of securities ratings.<sup>172</sup> This criterion raises the question as to whether niche players would be able to meet the proposed NRSRO requirements. In its proposed rule, the Commission remarks that an organization that has gained recognition for a limited sector of the debt market or a limited geographic area could meet this criterion. The SEC does not preclude an organization that relies primarily on quantitative statistical models from being recognized as an NRSRO.

*c. Systematic Procedures to Ensure Credible and Reliable Ratings*

The third component of the proposed NRSRO definition would require that the organization implement systematic procedures to ensure credible and reliable ratings. The SEC proposes eight factors that would be important in its assessment of whether an organization meets this component of the definition: (1) the experience and training of a firm's rating analysts; (2) the average number of issues covered by analysts; (3) the information sources reviewed and relied upon by the credit rating agency and how the integrity of information utilized in the ratings process is verified; (4) the extent of contacts with the management of issuers, including access to senior level management and other appropriate parties; (5) the organizational structure of the credit rating agency; (6) how the credit rating agency identifies and manages or proscribes conflicts of interest affecting its ratings business; (7) how the credit rating agency monitors and enforces compliance with its procedures designed to prohibit the misuse of material, nonpublic information; and (8) the financial resources of the credit rating agency.

Albeit through a different approach, these factors deal with issues that are similar to those addressed in the *IOSCO Code*.

**C. A Critical Look at Regulatory Strategies for Implementing Accountability-Enhancing Rules of Conduct**

The above initiatives are characterized by two main dimensions. The first relates to the substantive rules of conduct. In this respect, a comparison of the IOSCO and

---

<sup>172</sup> *Ibid.*

SEC initiatives indicates that both propose rules of conduct that deal with similar concerns. The second dimension relates to the regulatory strategy favoured to implement the rules of conduct. In this respect, the SEC and the IOSCO differ in their respective approaches. The SEC proposes to maintain the use of the NRSRO concept while clarifying the definition of this concept so as to ensure that it imposes clearer and arguably more demanding requirements with respect to agencies' organization and conduct. The IOSCO favours a self-regulatory approach based on a detailed model code of conduct. In Canada, David Brown, Chair of the OSC at the time, endorsed the statement of principles contained in the *IOSCO Report*.<sup>173</sup>

The IOSCO and SEC initiatives offer a good indication of the issues that Canadian regulators may have to consider dealing with in order to enhance the accountability of CRAs. Assuming that this is the case, the question to address becomes which strategy should be used to implement these substantive rules of conduct?

### 1. Self-Regulation with a Voluntary Code of Conduct

A first strategy would be to follow the approach suggested by the IOSCO pursuant to which CRAs should self-regulate through the adoption of voluntary codes of conduct.<sup>174</sup> A voluntary code of conduct could be developed by each individual rating agency or by an industry association. CRAs could even establish a voluntary industry association at a national, regional, or international level with the mandate to adopt a model industry code of conduct.<sup>175</sup>

With respect to content, CRAs could use the IOSCO model. In the case of an industry-wide code, adherence to the code would take the form of agreements between CRAs, which would imply a contractual obligation towards the association.<sup>176</sup> The contracts would provide for sanctions for breach of the code. In the case of an individual firm-specific code of conduct, it would be incumbent on the

---

<sup>173</sup> Ontario Securities Commission, News Release Communiqué, "OSC Chair Endorses International Standards for Analysts and Credit Rating Agencies" (26 September 2003), online: Ontario Securities Commission <[http://www.osc.gov.on.ca/About/NewsReleases/2003/nr\\_20030926\\_osc-iosco-standards.jsp](http://www.osc.gov.on.ca/About/NewsReleases/2003/nr_20030926_osc-iosco-standards.jsp)>.

<sup>174</sup> See generally Margot Priest, "The Privatization of Regulation: Five Models of Self-Regulation" (1998) 29 *Ottawa L. Rev.* 233 at 245-51; Industry Canada, *Voluntary Codes—A Guide for their Development and their Use* (Ottawa: Office of Consumer Affairs, March 1998) [*Voluntary Codes*], online: Industry Canada <[http://strategis.ic.gc.ca/epic/internet/inoca-bc.nsf/vwapj/volcodes.pdf/\\$FILE/volcodes.pdf](http://strategis.ic.gc.ca/epic/internet/inoca-bc.nsf/vwapj/volcodes.pdf/$FILE/volcodes.pdf)>.

<sup>175</sup> Giorgos Katiforis, European Parliament Committee on Economic and Monetary Affairs, *Report on Role and Methods of Ratings Agencies* (A5-0040/2004) (Committee on Economic and Monetary Affairs, 29 January 2004) at 7, online: European Parliament <<http://www.europarl.eu.int/omk>>.

<sup>176</sup> Industry Canada, *An Evaluation Framework for Voluntary Codes* (Ottawa: Office of Consumer Affairs, 2000), online: Industry Canada <[http://strategis.ic.gc.ca/epic/internet/inoca-bc.nsf/vwapj/EvluationFramework.pdf/\\$FILE/EvaluationFramework.pdf](http://strategis.ic.gc.ca/epic/internet/inoca-bc.nsf/vwapj/EvluationFramework.pdf/$FILE/EvaluationFramework.pdf)>.

board of directors to adopt the *IOSCO Code* as is, or with some modifications, and to ensure the enforcement of its provisions.

From an efficiency perspective, the use of a code of conduct would not involve significant administrative costs. The drafting of the code would be done by regulated entities themselves, rather than by the government. CRAs would thus mobilize their own expertise and resources towards the development of the code, thereby reducing drafting costs. Of course, they would also have the luxury of relying on the *IOSCO Code* in order to reduce drafting costs.

Given the small number of industry players at the regional and the international levels, a global industry code of conduct would be less expensive to produce through negotiations between leading agencies, rather than by the governments involved, because a consensus could be easier to obtain amongst industry members. Thus, the development of an industry code of conduct could be a relatively simple way of attaining the essential goal of harmonization.

For CRAs, adopting a voluntary code of conduct model could yield some benefits. This model would avoid the difficult question of setting requirements for the recognition of organizations as credit rating agencies. The CRAs would have the discretion of adopting the *IOSCO Code* “off-the-rack” or developing their own code of conduct. This would prevent the creation of additional barriers to entry and would reduce the risk of lowering competition. Because of its non-statutory nature, a code of conduct would be more flexible than regulation and could therefore adapt more rapidly and inexpensively to reflect changes in the industry. Moreover, adopting the *IOSCO Code* would assist rating agencies in bonding their credibility vis-à-vis market participants thereby attenuating the potential agency problems outlined above. However, this approach would not remove the barriers to entry that can result from the current regulatory use of ratings.

To be sure, the participation of CRAs in drafting an industry code could have some drawbacks. In the case of an industry code, the large agencies could use their clout to exercise control over the essence of the code, thereby emphasizing requirements that may prove ill-suited for smaller rating agencies. Likewise, the large CRAs could take advantage of their power to include anticompetitive provisions in the industry code.<sup>177</sup> Although agencies would be free not to adhere to such an ill-suited code, failure to do so could be perceived negatively by market participants who consider the code to be an industry standard. Under similar circumstances, the industry code of conduct could become a barrier to entry. This drawback would however be avoided by using the *IOSCO Code* as the model for the industry code.

From an accountability perspective, the use of an industry code would give rise to several challenges. The first relates to the openness of the code’s development. If left solely in the hands of CRAs, the drafting of the code may leave little place for

---

<sup>177</sup> See generally Swire, *supra* note 157; *Voluntary Codes*, *supra* note 174 at 6.

involvement by stakeholders.<sup>178</sup> This may limit the effectiveness of the code in addressing the concerns raised by the activities of CRAs with respect to the public. To alleviate this problem, the code would have to be developed using a process that provides for some involvement of market participants as well as other members of the public. In this respect, the proposition of the IOSCO appears particularly interesting in that the model code is the product of consultations with regulators and market participants.

The second and most important challenge of this option relates to compliance and enforcement.<sup>179</sup> Reputation would be the main incentive leading CRAs to adopt a code of conduct modelled on the *IOSCO Code*, and to respect its provisions.<sup>180</sup> However, the voluntary code of conduct option does not provide any solution to the limits of reputational pressures. Furthermore, if the degree of disclosure is left to the discretion of CRAs, there is a possibility that “the market would not be properly informed on how—and in which measure—the CRAs are implementing the IOSCO Code.”<sup>181</sup> It is true that a code would operate within the existing legal and regulatory landscapes. The principles set forth in the code would influence the construction of the legal duties and liabilities imposed upon CRAs, thereby extending the effects of the code in favour of third parties.<sup>182</sup> Reliance on the existing legal regime to ensure the enforcement of the provisions of the code remains a questionable approach. In the absence of effective compliance and enforcement mechanisms, it remains unclear whether CRAs could be held accountable to market participants.<sup>183</sup> Ultimately, the adoption of a code of conduct by CRAs could amount to nothing more than mere window dressing.<sup>184</sup>

## 2. Strategies Regulating both Entry and Conduct

Rather than follow the IOSCO approach, Canadian regulators could devise a strategy modeled on the U.S. approach to regulate both entry and conduct within the CRA industry. This strategy could be implemented through supervised self-regulation or a registration model.

---

<sup>178</sup> Priest, *supra* note 174; *Voluntary Codes*, *ibid.* at 6-7.

<sup>179</sup> See Harvey L. Pitt & Karl A. Groskaufmanis, “Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes Of Conduct” (1990) 78 *Geo. L.J.* 1559 at 1604-605.

<sup>180</sup> *CESR's Technical Advice*, *supra* note 5 at 42.

<sup>181</sup> *Ibid.* at 43.

<sup>182</sup> See e.g. Priest, *supra* note 174; *Voluntary Codes*, *supra* note 174 at 27.

<sup>183</sup> *CESR's Technical Advice*, *supra* note 5 at 43.

<sup>184</sup> Raymonde Crête, “L’implantation des codes d’éthique dans le milieu des affaires québécois et canadien — Quelques réflexions sur les pratiques actuelles” in *Développements récents en droit commercial* (Cowansville, Qc.: Yvon Blais, 1998) 135; See Pitt & Groskaufmanis, *supra* note 179 at 1604-605.



a. *Supervised Self-Regulation*

To establish a system of supervised self-regulation CRAs would form an association that would file an application with the securities commission for recognition as a self-regulatory organization (“SRO”).<sup>185</sup> Once recognized, the SRO would be responsible for regulating the operations, the standards of practice, and the business conduct of its members. Membership would be mandatory in order for agencies to gain access to the status of “approved credit rating organization” under the various legal regimes. The SRO would set the membership requirements and establish rules governing credit rating, which would be binding on the members through contractual arrangements. In this respect, the SRO could use the *IOSCO Code* as a model. The SRO would also have the ability to monitor behaviour of its members and impose sanctions. The regulatory activities of the SRO would be subject to continuous oversight by securities commissions.

Supervised self-regulation has developed primarily in the securities industry. The *Securities Act* already establishes a framework to deal with SROs.<sup>186</sup> In a nutshell, the Act provides that SROs may seek recognition from the Commission. Where an SRO is recognized, it becomes subject to the oversight of the Commission. Presently, recognition is only mandatory for stock exchanges. SROs that are not recognized may nevertheless set standards of conduct that will apply to their members on a voluntary basis. These SROs are not subject to the oversight of the securities commission.

From an efficiency perspective, reliance on supervised self-regulation could have some beneficial impact. Recognition by the SRO could increase the perceived status of newer CRAs.<sup>187</sup> Moreover, supervised self-regulation could provide an additional mechanism to foster loyalty amongst rating agencies towards issuers and investors, thereby attenuating agency problems. Recognition would signal to the market that the SRO considers that the rating agency has proper mechanisms in place to ensure rating accuracy and integrity. It would also indicate that the agency has accepted to be subject to the ongoing monitoring and sanctions of the SRO.

Whether these efficiency gains justify the adoption of an SRO model is debatable. Firstly, the SRO model would imply the adoption of recognition criteria for CRAs that could rapidly become barriers to entry. For instance, the adoption in Canada of any of the conditions embedded in the proposed definition of NRSRO would likely have a negative impact for would be entrants. The SRO model would also involve higher compliance costs for CRAs than in a pure self-regulation

---

<sup>185</sup> On supervised self-regulation, see Peter Dey & Stanley Makuch, “Government Supervision of Self-Regulatory Organizations in the Canadian Securities Industry” in *Proposals for a Securities Market Law for Canada*, vol. 3 (Ottawa: Minister of Supply and Services Canada, 1979) 1399; Johnston & Rockwell, *supra* note 149 at 279ff; David Mullan & Antonella Ceddia, “The Impact on Public Law of Privatization, Deregulation, Outsourcing, and Downsizing: A Canadian Perspective” (2003) 10 *Ind. J. Global Legal Stud.* 199 at 216-18; Priest, *supra* note 174.

<sup>186</sup> *Securities Act*, *supra* note 124, ss. 21.1-21.11.

<sup>187</sup> *CESR’s Technical Advice*, *supra* note 5 at 45.

regime.<sup>188</sup> Although the rules of conduct would be similar under both regimes if the model of the *IOSCO Code* were to be followed, supervised self-regulation would impose mandatory rules of conduct to rating agencies. Each rating agency would have to follow the rules of conduct enacted, whether or not they are justified and cost-effective. Furthermore, CRAs would be subject to potentially costly regulatory oversight absent under the self-regulation model.

Second, in order for the efficiency gains to materialize, the SRO would have to avoid being captured by the large CRAs. There is a risk that the SRO would actually wind up being accountable primarily to its members. Specifically, the SRO could face a conflict of interest because of its dual role as regulatory body acting in the public interest, on the one hand, and as protector and promoter of the private interests of its members on the other hand. This conflict of interests could extend to the rulemaking process, by leading the SRO to adopt entry requirements that are in the interest of incumbents for instance, making it difficult for newer firms to satisfy them. With respect to enforcement, the potential conflict of interests of the SRO could lead it to be less severe toward its members.<sup>189</sup>

In a system of supervised self-regulation, securities commissions would have oversight powers over the SRO, enabling them to review and approve its bylaws, and to hear appeals from decisions rendered by the SRO. They would also have the power to compel an SRO to retain an auditor to conduct compliance reviews. The ability of the commission to oversee the SRO would provide an accountability mechanism for the latter. Still, the extent of such supervisory power is limited by the commission's own experience and expertise, which may prevent them from adequately evaluating the SRO's decisions and initiatives. Furthermore, commissions could themselves be captured by the SRO's members.

In any case, supervision of the SRO by the securities commissions would entail expenses that would raise administrative costs. When calculating these costs, it is necessary to take into account the expenses incurred by securities commissions to oversee the SRO's activities. Thus, the savings generated by self-regulation may rapidly evaporate.

#### *b. Registration Model*

Registration is an approach frequently employed to regulate securities market professionals.<sup>190</sup> Under a registration system, rating agencies would have to register with the competent securities commission. Registration conditions would be

---

<sup>188</sup> *Ibid.* at 46.

<sup>189</sup> See René Sorell, "Supervision of Self-Regulatory Organizations in Ontario's Securities Market" in *Securities Regulations: Issues and Perspectives: Papers Presented at the Queen's Annual Business Law Symposium, 1994* (Scarborough, Ont.: Carswell, 1995) at 178, 182-83; Fisch & Sale, *supra* note 56 at 1096.

<sup>190</sup> Mark R. Gillen, *Securities Regulation in Canada*, 2d ed. (Toronto: Carswell, 1998) at 432-44.

established in rules of the commission, which would have broad discretion in deciding whether or not to grant registration. Registration would be subject to an annual renewal process.

As registrants, CRAs would become subject to regulatory requirements developed by the securities commission aimed at addressing the concerns raised by their activities. The commission could establish oversight mechanisms that would provide it with information on the registrants, and enable it to conduct inspections and examinations. To sanction non-compliance with regards to requirements, the commission would have the ability to use its power to reprimand, suspend, cancel or restrict registration with respect to a particular CRA.

From an efficiency perspective, a registration system could be beneficial for new or smaller agencies in that it would provide them with regulatory recognition of their expertise and qualifications.<sup>191</sup> By granting them regulatory approval, the system would provide issuers with more alternatives, thereby boosting competition in the industry. Moreover, putting securities commissions in charge of the regulation and supervision of CRAs could enhance their accountability to the public thereby providing an additional bonding mechanism.

The registration system is not flawless. A first concern is that the beneficial impact of the system on competition is dependant on the registration system being finely tuned both in terms of the recognition criteria and the ongoing rules of conduct it imposes. A flawed framework would create significant barriers to entry for emerging firms given the mandatory nature of the registration system.<sup>192</sup> For instance, the adoption of the proposed NRSRO recognition criteria could have a negative impact in Canada.

The enactment of a finely-tuned registration system could prove costly. It would involve administrative costs in the form of expenses associated with gathering expertise and drafting of rules. Admittedly, these costs would be lower if the securities commissions agreed to base their registration system on the *IOSCO Code*. Still, the commissions would also have to incur costs to consult industry players during the rulemaking process. In this respect, proponents of public choice theory will argue that regulators will have to expand resources in order to ensure that they are proceeding in the public interest.<sup>193</sup> A powerful interest group such as the CRAs could, to some extent, capture the regulators and impose registration requirements that restrict entry by new players. Moreover, drafting costs would be magnified by the necessity to develop a regulatory framework through a joint process involving both

---

<sup>191</sup> *CESR's Technical Advice*, *supra* note 5 at 40.

<sup>192</sup> *Ibid.* at 45.

<sup>193</sup> Mary G. Condon, *Making Disclosure: Ideas and Interests in Ontario Securities Regulation* (Toronto: University of Toronto Press, 1998); Patrick Moyer, "The Regulation of Corporate Law by Securities Regulators: A Comparison of Ontario and the United States" (1997) 55 U. T. Fac. L. Rev. 43 at 66.

Canadian and foreign securities commissions, in order to ensure harmonization, with an uncertain result.

A second concern relates to accountability. A government regulator may be less successful than an SRO in the development of effective ethical norms.<sup>194</sup> If this is indeed the case, registrant compliance with respect to rules of conduct could be hampered and could increase costs for the regulator to ensure enforcement. Others question whether the securities commissions have the expertise to review and assess the procedures used by CRAs to ensure an effective enforcement of the regulatory framework.<sup>195</sup> If expertise is lacking, the rules imposed by the registration system may have little impact on the conduct of CRAs' activities.

#### ***D. Strengthening Market-based Solutions Through a Measured Regulatory Intervention***

None of the main regulatory strategies reviewed above are entirely satisfactory. This does not imply that the *status quo* is the preferred option. Rather, it suggests that a more customized approach to regulating CRAs is needed, one that acknowledges that the market failures “exist alongside incentives among ... market participants to ameliorate those failures ...”<sup>196</sup> In such a setting, regulators would be able to contribute by assisting the market with limited intervention. Regulators could seek to enhance the accountability of CRAs by assisting them to bond their credibility toward investors. As suggested below, a disclosure strategy appears well-suited to attain this goal.

##### **1. A Disclosure Strategy to Reinforce Private Accountability Mechanisms**

Regulation could seek to reinforce the effectiveness of reputation by imposing disclosure obligations on rating agencies. Specifically, regulators should require that rating agencies disclose their codes of conduct to the public and indicate to what extent their provisions are consistent with the *IOSCO Code*. Where the provisions of a CRA's code of conduct would deviate from the Code's provisions, the agency would have to explain where and why these deviations exist, and whether such deviations nevertheless achieve the Code's objectives. In addition, rating agencies would be required to describe what mechanisms are in place to ensure the enforcement of the provisions of their codes. Finally, any material changes to the provisions of an agency's code should be disclosed publicly.

---

<sup>194</sup> See Dey & Makuch, *supra* note 185 at 1436-37; Joel Seligman, “Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission” (2004) 59 *Bus. Law.* 1347 at 1361-62.

<sup>195</sup> See Rhodes, *supra* note 9 at 358.

<sup>196</sup> Choi, “Framework”, *supra* note 112 at 71.

Generally speaking, disclosure would be an effective mechanism to assuage concerns over CRAs' lack of accountability.<sup>197</sup> Mandatory disclosure about codes of conduct may have the desired effect of exerting additional disciplinary pressures on rating agencies. Disclosure would assist investors in ascertaining the reputation of CRAs by permitting them to identify those that have adequate mechanisms in place to protect against abuses. Investors' assessments would be reflected in overall appreciation of the credibility of the ratings. Where investors would doubt the accuracy or independence of ratings, issuers would tend to avoid the latter and seek a more credible agency or an alternate mechanism to signal their creditworthiness. In this respect, the disclosure of CRAs' codes of conduct could lead other information intermediaries to "rate" agencies themselves thereby magnifying reputational pressures.

This proposal must be considered in light of two important caveats. The first is that in order for disclosure to reinforce reputational pressures, issuers must have the ability to use other raters or types of signaling mechanisms. Otherwise, issuers will remain trapped with the same rating agencies. This caveat underscores the need to review the regulatory use of ratings in order to allow entry by new or small rating agencies as well as to ensure the availability of alternate rating mechanisms.

The second caveat involves the impact of the disclosure strategy in itself on competition. It must be acknowledged that disclosure obligations would have little positive effect on entry. New rating agencies would derive some reputational gains from disclosing their codes of conduct in a comparative perspective. Still, in the absence of a track record, the reputational gains would likely remain marginal since investors and issuers are more concerned (in the effectiveness of the agency) with the assessment of credit risk.

## 2. The Implementation of the Disclosure Strategy

Who should be in charge of regulating credit rating agencies? The functional approach to regulation advocated by Merton is instructive in complementing this question.<sup>198</sup> This theory proposes regulating financial market participants on the basis of the economic functions they provide. While different regulatory regimes refer to ratings, CRAs are essentially informational intermediaries. Applying a functional approach to regulation, the activities of CRAs should fall under the jurisdiction of securities commissions. The latter are in charge of ensuring the application of securities regulation, which purports to reduce information asymmetries between issuers and investors. Thus, securities commissions have expertise with respect to the critical function occupied by CRAs. Furthermore, securities commissions already

---

<sup>197</sup> See Warren M.H. Grover & James C. Baillie, "Disclosure Requirements" in *Proposals for a Securities Market Law for Canada*, *supra* note 185, 349 at 385.

<sup>198</sup> Robert C. Merton, "A Functional Perspective of Financial Intermediation" (1997) 24:2 *Financial Management* 23.

regulate or oversee other capital markets informational intermediaries. Granting jurisdiction to securities commissions would thus improve regulatory efficiency. Centralizing regulatory oversight in the hand of one type of regulator would also contribute towards limiting compliance costs.

Securities commissions could take formal jurisdiction over rating agencies through the concept of market participant.<sup>199</sup> Specifically, the commissions could use their rule-making power to adopt a rule providing that any organization performing securities rating activities should be considered a market participant.<sup>200</sup> Each organization would have to “register” with the relevant securities commission and comply with the disclosure regime outlined above. The registration process would not impose entry requirements. It would serve as a tool for providing securities commissions with basic information concerning organizations qualified as market participants. It would also enable the commissions to establish contact with those organizations subject to the disclosure regime.

In parallel, it is suggested that securities commissions amend their rules and policies so as to ensure that the concept of approved rating organization refers to any organization registered with the securities commissions under the proposed rule. Likewise, federal and provincial authorities referring to specific rating agencies in their legislation and regulations should consider making similar changes.

The regulatory change proposed would enhance the accountability of rating agencies. It would grant oversight powers to securities commissions with respect to CRAs. As market participants, rating agencies would have to keep such books, records and other documents as are necessary for the proper recording of their business transactions and financial affairs.<sup>201</sup> They would have the obligation to make these books, records, and documents available to commissions when necessary. Furthermore, rating agencies would have to keep their codes of conduct on file with the commissions as well as those documents identifying the code’s conformity with respect to the *IOSCO Code*. To ensure enforcement of these obligations, the commissions would have the power to conduct compliance reviews. More importantly, as market participants, CRAs would be subject to the commissions’ power to make decisions in the public’s interests.<sup>202</sup> Finally, the designation of CRAs as market participants would reinforce the disciplinary effect flowing from the threat of additional regulatory interventions.

Second, the proposed regulatory change would remove at least one potential barrier to entry. Indeed, the designation of specific rating agencies as “approved rating organizations” is not without significance. It bolsters the reputation of these agencies by giving them regulatory imprimatur. In addition, it creates a potential

---

<sup>199</sup> *Securities Act*, *supra* note 124, s. 1.

<sup>200</sup> *Ibid.*, s. 143(1).

<sup>201</sup> *Ibid.*, ss. 19-20.

<sup>202</sup> *Ibid.*, s. 127.

barrier to entry for new firms that cannot act as rating agencies so long as they are not recognized by regulators and so long as the regulation has not been amended. The fuzziness surrounding the recognition process and criteria exacerbates the problem facing new entrants.

Nonetheless, the impact of this modification on the credit rating industry should not be overstated. The NRSRO designation enacted by U.S. regulation and legislation exercises a strong influence on the Canadian rating agency industry as well. Rating agencies that have the NRSRO status have considerable clout in Canada.<sup>203</sup> Canadian issuers making debt offerings will tend to prefer dealing with a rating agency that has the NRSRO status since it will facilitate access to the U.S. market. Nevertheless, the proposed modification would be relevant for new rating agencies that target a specific niche and that may not attract issuers seeking to tap the U.S. market.

Would these potential benefits be offset by the costs of this new regime? From the perspective of rating agencies, the disclosure obligations would not impose significant compliance costs.<sup>204</sup> Rating agencies would have to incur the costs of drafting a document presenting their codes of conduct in a comparative perspective with the *IOSCO Code*. Drafting costs should be relatively low given the scope of the disclosure obligations. As for the costs of disseminating the document, they should also remain minimal. Regulation should only require that agencies file the disclosure document with securities commissions on an annual basis, and that CRAs should only be required to make this document available to the public in an electronic format, which would spare them considerable printing costs. Similarly, the obligation to keep books and records would impose negligible additional expense to rating agencies, which are already equipped with comparable internal control mechanisms. Thus, it is unlikely that the compliance costs associated with the production of the proposed regime would create a barrier to entry for new rating agencies.

The regime would not generate significant administrative costs either. The disclosure obligations would be enacted in the rule applying to organizations performing rating activities. In this respect, drafting the rule should not entail extensive analysis or consultation by regulators. As mentioned previously, the “registration” of rating agencies would not involve the enactment of recognition criteria. The proposed “comply or explain” approach is already used by securities regulators with respect to corporate governance disclosure. Furthermore, disclosure requirements would not be overly extensive or complicated. In terms of enforcement, the number of interventions by securities commissions would be relatively limited by the small number of rating agencies, the frequency of filings, and the relatively neutral character of the information disclosed.

---

<sup>203</sup> See *supra* note 51 and accompanying text.

<sup>204</sup> See Zingales, *supra* note 159 at 3, 19.

## Conclusion

Credit rating agencies play a central role in financial markets. Their views on creditworthiness have normative implications for market participants. Creditworthiness influences the conditions under which issuers access debt markets. It also plays a significant part in investors' portfolio decisions. Whether or not they are considered to be accurate or relevant, ratings shape market participants' conduct.<sup>205</sup> Put plainly, CRAs are economic agents who wield power over issuers and investors.

In a perfectly functioning market, the fact that CRAs have such power would not be a cause for concern. Specifically, issuers and investors would have the means to ensure that CRAs' interests are aligned with their own. As seen above, the real world departs from this ideal, and failures in the market may lead to a disconnect between the interests of CRAs on the one hand, and those of issuers and investors on the other. The review of the legal and institutional environment indicates that there is a dearth of mechanisms designed to ensure accountability. In fact, it would appear that reputation is the primary, if not the only, mechanism that acts to restrain opportunistic behaviour on the part of rating agencies. Thus, there is a potential accountability gap, that is, an imbalance between CRAs' vast power and the likelihood of holding them responsible for their use of this power.

This accountability gap has preoccupied regulators ever since the recent wave of corporate scandals. Although studies conducted revealed no wrongdoing on the part of CRAs, they warned of potential problems that could result if reputation were to fail in reigning them in. As a result, regulators have examined possible methods of enhancing the accountability of rating agencies: the IOSCO published the *Code of Conduct Fundamentals for Credit Rating Agencies*, and the SEC proposed a rule that would define the conditions an entity must satisfy in order to obtain an NRSRO designation. While both these initiatives deal with similar issues, the *IOSCO Code* is better suited to implementation in national regulations than the SEC rule, which is idiosyncratic to the American system. To the extent that the *IOSCO Code* sets forth principles that should be adopted in order to shape the conduct of CRAs, the question of how it should be implemented by Canadian regulators remains.

This paper argues that the implementation of the *IOSCO Code* should be done through a "comply or explain" disclosure strategy. Securities commissions would be charged with overseeing the disclosure strategy and would retain jurisdiction over CRAs by assigning them the status of "market participant". The proposed approach would contribute to enhancing the accountability of CRAs not only by reinforcing reputational pressures that guard against opportunism, but also by introducing an additional level of regulatory supervision over them that could hold them responsible for such behaviour.

---

<sup>205</sup> See Sinclair, *supra* note 1 at 52.