Chapter 3

CREDIT RATING AGENCIES: FINANCIAL MULTIPOLARITY, EU REGULATORY EXPORT AND THE DEVELOPMENT OF GLOBAL STANDARDS THROUGH MULTILEVEL GOVERNANCE

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I. INTRODUCTION

The global financial crisis exposed some of the regulatory and market failures of a more and more globalized financial system and led to far-reaching discussions about a broad range of academic and policy issues on the regulation of financial services. While the causes of the financial crisis remain controversial, one factor clearly deserves our attention: the lack of substantive principles and 'hard law' in the international financial architecture and its accompanying regulatory apparatus, particularly regarding cross-border financial institutions, such as credit rating agencies (hereinafter "CRAs").

CRAs are major players in today's financial markets, with ratings having a direct impact on the actions of investors, borrowers, issuers and governments. The "Big Three" global CRAs – the US-based Standard and Poor's and Moody's and the dual-headquartered (in New York and London) Fitch Ratings – have been under intense scrutiny. They were initially criticized for their favorable pre-crisis ratings of insolvent financial institutions like Lehman Brothers, as well as risky mortgage-related securities that contributed to the collapse of the US housing market. Since the spring of 2010, CRAs have focused on US and European sovereign debt. That resulted in Standard and Poor's unprecedented downgrade of the US' long-held triple-A rating in August 2010. Greece, Portugal and Ireland have all been downgraded to "junk" status. As the current Eurozone crisis highlights, a sovereign downgrading can have vast implications not only in the financial markets, but also for the respective state itself.

However, financial multi-polarity and re-regulation make global regulatory consolidation and full harmonization from a *top-down* approach in the CRAs industry an even more distant prospect than was the case before the crisis. It would be easier to harmonize when one country or one bloc dominates than when many diverging voices need to concur for a decision to be made; the latter being a condition more conducive to global regulatory fragmentation than the achievement of global standards. The declining relative importance of US capital markets in recent years and the lessons learned from the inward-looking Sarbanes-Oxley Act; emerging markets that have developed sophisticated and highly liquid financial centers that attract foreign investors, including US investors; fierce competition among both established and up-and-coming global financial centers in Asia and the Middle East. All have created an entirely new atmosphere. It would be also easier to harmonize rules in an era of deregulation, by reaching agreement on a low common denominator. Expectations as to what the rules should achieve, levels of financial development, governments' interest in financial regulation (and technical capacity to discuss it), may vary hugely from one jurisdiction to another.

Against this backdrop, the purpose of this chapter is to explore the prospects of harmonization and the development of global standards in light of a current fragmentation of regimes as well as the actors involved in rule-making. It does so by proposing the idea of imposing higher regulatory standards via extraterritoriality and private sector governance in the CRAs industry.

In particular, this chapter investigates the role of the European Union (EU) "territorial" authority, providing a view on the role of the EU regulator as source of international financial law in the wake of the recent global financial turmoil. Although scholars have long recognized the extraterritorial effects of various financial rules, extraterritoriality is generally examined in the context of the conflicts of law literature. This article intends, instead, to explore the possibilities of extraterritoriality as a regulatory strategy, specifically looking at equivalence clauses used to export the EU regulatory model. This under-explored issue is contextualized in the credit rating industry by investigating how EU law interacts with global law and standards in the industry. To carry out this analysis, we scrutinize the "equivalency" device, the legal means by which the EU regulator unilaterally exerts its influence in the CRA industry. First mover dynamics, linked to equivalence mechanisms,

are evident in the EU CRAs Regulation (hereinafter the "EU Regulation")[1]. The *equivalence* device serves to "export" the EU regulatory model. If a non-EU regulator wishes to allow CRAs domiciled within its jurisdiction the right to issue ratings for use in the EU, but does not already have a regulatory regime at least as stringent as the EU's one, it may have to comply with the EU Regulation, including entering into cooperation agreements with EU regulators. There are some early indications that the equivalence regime has been used by the EU to press for changes to the US, Japanese and Canadian rating regime. This may make the EU forging ahead of global standard-setters.

The credit rating industry is an excellent area in which to show readers how this concept might work. CRAs and the markets they serve have global nature. This sector is characterized by the mobility of the rating service, which may be easily provided from varying locations (e.g. a German analyst operating in a London office of an American CRA producing a rating on an Italian company) and by the cross-border impact of ratings on users located beyond the geographical limits of a jurisdiction (e.g. ratings issued by a Japanese CRA may be used for calculating risk capital by banks in various EU Member States).

Beside territoriality, we examine the capacities of private governance in the industry. We find that there is a role also for the CRA-industry private sector governance – via their self-regulatory Code - in informing the strength of international financial standards in the industry.

In such a heterarchic system of governance, efficiency does not seem to result from a clear hierarchy of norms, but draws from open competition and cooperation among various types of regulators.

II. CREDIT RATING AGENCIES REGULATION AFTER THE CRISIS

CRAs play a powerful and highly contentious role in the global financial system. The regulatory system relies on their assessments, transferring a "quasi-regulatory", and thus public authority, to the agencies. This reliance is observed in bank regulation, which in some circumstances sets banks' capital requirements in relation to asset risks as assessed by the rating agencies. Similar regulations exist for insurance and other financial market participants.[2]

Basel II contributed to the increasing use of credit ratings for regulatory purposes on a global scale.[3] Meanwhile, credit ratings continued to play a major role in global banking-sector regulations under Basel III, which mandates banks to justify their tier-one assets as part of liquidity requirements with reference to CRAs.

The incorporation of ratings in standards and regulations contributes significantly to market reliance on ratings, thus dramatically reducing banks', institutional investors' and other market participants' own capacity for credit

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[1] Regulation No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, OJ L 302, 17.11.2009.

[2] The regulatory incorporation of CRAs has been more developed in the US. In 1975, the SEC adopted the term "nationally recognized statistical rating organization" (NRSRO) to determine appropriate capital charges for broker-dealers under the SEC's net capital rule according to an objective benchmark. In 1981, the SEC changed its historic practice of precluding the disclosure of ratings in securities offerings and encouraged such disclosure. *See* Disclosure of Ratings in Registration Statements, Securities Act Release No. 6,336, 46 Fed. Reg. 42,024 (Aug. 6, 1981); Adoption of Integrated Disclosure System, Securities Act Release No. 6,383, 47 Fed. Reg. 11,380 (March 3, 1982). Marketplace and regulatory reliance on credit ratings then gradually increased, and the concept of "investment grade" securities, as approved by an NRSRO, became embedded in a wide range of US regulation of financial institutions, as well as laws relating to credit worthiness.

[3] Banks were permitted to use ratings from certain accredited CRAs (ECAIs, External Credit Assessment Institutions) to determine minimum credit risk capital requirements under Pillar I of the Basel Capital Accord (Basel II).

risk assessment. This in turn was a cause of the "cliff effects" of the sort experienced during the recent crisis, through which rating downgrades can amplify procyclicality and cause systemic disruptions.

The inherent conflict between their *status* as private, profit seeking entities and the status of a quasi-public regulator is even more remarkable because they not only have continued to operate with little government regulation, but have been also largely exempted from established legal standards applying to traditional forms of investment advice in the US and the EU. Even worse, market discipline such as reputation – which has traditionally been the preferred course of action – did not provide sufficient restraint during the crisis. There appeared to be an "accountability gap".

The extensive reforms that have been introduced internationally in the CRAs' industry as a result of the crisis have brought to a halt the reliance on self-regulation and market discipline as primary regulatory mechanism. A strong consensus emerged that international self-regulatory efforts should have been supplemented with regulation of CRAs by national competent authorities. This consensus was encapsulated by the G-20 in 2009[4], which stated that all CRAs whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime that includes registration and is consistent with the IOSCO Code on CRAs[5]. Overall, reviews by regulators in the EU, US and other jurisdictions (including Japan, Australia, Mexico and Hong Kong), led to greater regulation and supervision in the industry, in order to ensure good governance, manage conflicts of interest and improve transparency and quality of ratings.

In the US, initiatives to establish government regulation of CRAs began before the emergence of the crisis. They culminated with the enactment of the *Credit Rating Agency Reform Act* in 2006[6], which established a system of registration and regulation of NRSROs and instructed the SEC to formulate implementing rules. The Commission adopted rules in 2007[7] and 2009[8] implementing the requirements of the Act and reflecting concerns about the performance of the CRAs in the lead up to the financial crisis.

Several important reforms affecting CRAs were then included in the omnibus financial services reform legislation, the *Dodd-Frank Wall Street Reform and Consumer Protection Act*[9] (hereinafter, Dodd-Frank Act). The Dodd-Frank Act provides for more intensive and effective regulation of NRSROs, overseen by the Office of Credit Ratings at the SEC. The Act requires the SEC to adopt rules that will significantly increase the regulation of CRAs under the securities laws. The statute and its implementing regulations affect everything from rating methodologies to the corporate governance of the organizations themselves. At the same time, they will make the ratings of NRSROs much more transparent and easier for third parties to evaluate. The sanctions for failure to adhere to the statute and regulations are severe and may lead to the revocation of the registration of an agency with the SEC.

One key change redefined CRAs as "experts" and exposed CRAs to "expert" liability.[10] This would allow investors to bring private rights of action against the agencies if their ratings are found to be inadequate.[11] Other

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[4] G-20, *Declaration on Strengthening the Financial System.*

[5] *Code of Conduct Fundamentals for Credit Rating Agencies,* Report of the Technical Committee of IOSCO. The IOSCO Code, published in December 2004 and updated in May 2008, is 'a set of robust, practical measures that serve as a guide to and a framework for implementing' the objectives of IOSCO *Statement of Principles Regarding the Activities of Credit Rating Agencies* (Principles) of 2003.

[6] Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291 (2006).

[7] SEC Release No. 34-55857 (June 18, 2007).

[8] SEC Release No. 34-59342 (February 2, 2009).

[9] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[10] Issuers in the US at times have included the rating for a security in the related public offering registration statement. Under the SEC's Rule 436(g), issuers have been able to include those ratings without obtaining consent from the NRSRO issuing the rating. The legislation repeals 436(g), potentially exposing NRSROs to "expert" liability if they provide consent for ratings to be included in registration statements.

provisions of the legislation that have received public attention and concern are the repeal of the NRSRO exemption to Regulation Fair Disclosure (Reg. FD)[12] and a change in the pleading standard for federal securities fraud claims against CRAs[13]. The Act also removes statutory references to credit ratings in several areas of federal law and calls for federal agencies to review their use of credit ratings in rules and regulations.

III. THE EU REGULATION AND ITS EXTRATERRITORIAL EFFECTS

Prior to the financial crisis, there was no comprehensive regulation of CRAs in the EU.[14] Their regulation consisted primarily of self-regulatory guidelines established pursuant to the IOSCO Code. This self-regulatory approach (with minimal statutory obligations) has been viewed to be sufficient.

The crisis caused a sharp reversal of regulators' opinions. Rapid action was taken to significantly reinforce and expand the IOSCO Code through the enactment of the first comprehensive regulation on CRAs in the EU [15], requiring their registration and oversight.[16] It requires that all CRAs established in the EU seek authorization from the relevant national authorities and, among other things, provides that only credit ratings issued by CRAs subject to the new Regulation can be used by entities based in the EU for regulatory purposes. The EU Regulation has been amended in May 2011[17] to entrust the European Securities and Markets Authority (ESMA) with exclusive supervisory powers over CRAs registered in the EU in order to centralize and simplify their supervision at European level.

The EU Regulation imposes a comprehensive set of binding rules, taking a much more prescriptive approach to regulation than both the IOSCO Code and the Dodd Frank Act. It addresses substantive operational and organizational issues and involves detailed requirements pertaining to registration, corporate governance, rating methodologies and ongoing supervision.

The scope of the EU Regulation extends to CRAs located outside of the EU, allowing the use of a credit rating issued by a third-country CRA only when the rating activities are either endorsed by a CRA located in the Community[18] or comply with certification based on equivalence.[19]

The endorsement regime allows CRAs registered in the EU to endorse credit ratings issued in third-countries if the conduct of credit rating activities by the third-country CRA complies with requirements (relating to conflicts of interest, rating analysts, methodologies, outsourcing, disclosure and transparency) that are at least *as stringent as* the EU requirements, achieving the same objective and effects in practice.[20] In order to respond to concerns

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[11] However, all the major CRAs have indicated they will not consent to their ratings being used in registration statements and prospectuses.

[12] The NRSRO exemption from the SEC's Reg. FD has permitted issuers to share material non-public information with NRSROs without triggering broader disclosure requirements. The legislation eliminates this exemption.

[13] The legislation changes the pleading standards for CRAs. This could potentially lead to more suits as the change may permit claims of federal securities fraud to be brought against a CRA that allegedly "knowingly or recklessly failed to conduct…a reasonable investigation…or to obtain reasonable verification" of the data it relies on to determine credit ratings.

[14] The Market Abuse Directive regulated only limited aspects of CRAs activities.

[15] See fn. 1.

[16] CRAs were required to apply the majority of the regulation by December 7, 2010, while the provisions relating to endorsement by June 7, 2011. *Id.* art. 41.

[17] Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies, OJ L 145, 31.5.2011.

[18] EU Regulation, art. 4.

[19] Id., art.5.

[20] Id., art. 4(3)(b).

that lack of establishment in the Community may be a serious impediment to effective supervision, third-country CRAs are required to set up subsidiaries in the EU.[21]

The other option for the use of credit ratings issued in third countries is certification based on *equivalence.* One of the certification conditions for a foreign CRA is that the Commission has adopted an equivalence decision recognizing the legal and supervisory framework of the third country as equivalent to the requirements of the Regulation.[22] The equivalence mechanism does not grant automatic access to the Community, but offers the possibility for qualifying third-country CRAs to be assessed on a case-by-case basis and be granted an exemption from some of the organizational requirements for CRAs active in the Community, including the requirement of physical presence in the Community. For example, the requirement of physical presence in the Community has been adjusted in certain cases, notably as regards smaller CRAs from third countries with no presence or affiliation in the Community.[23]

The endorsement regime was designated primarily for the initial stage of the application of a new regulatory regime for credit ratings in the EU, until decisions on *equivalence* are made in respect of major jurisdictions. Equivalence decisions should later enable relatively more flexibility for credit ratings issued by CRAs established in countries deemed to have an equivalent regulatory regime as those to be used for regulatory purposes in the EU. Secondarily though, as was discussed during the negotiation, was that CRAs whose credit ratings may have significant impact on the European financial markets should always have physical establishment in the Community in order to be supervised directly by the competent authorities from the EU and eventually to be held responsible for complaints of users of their credit ratings. This means that any third-country CRA which is considered *systemically important*[24] must establish a subsidiary within the Community.

It was questioned if the EU Regulation establishes two different tests for third-country CRAs depending on which mechanism used: “at least as stringent as” versus “equivalent to”. According to ESMA ,[25] there are no objective reasons to set different requirements: where the European Commission has recognized that the regulatory regime of a third country is equivalent to the CRA Regulation, it is possible to refer to this decision in respect to the “as stringent as” test for endorsement.

Both the certification and endorsement provisions could have considerable extraterritorial implications.

The EU Regulation is imposed on CRAs regardless of where they are domiciled. The three largest CRAs – Standard and Poor’s, Moody’s and Fitch – are based in the US, but have a significant cross-border presence in all financial markets, including the UK and, more generally, Europe.[26] They are now subject to conflicting regulations in the US and the EU[27] and may also feel compelled to comply with the revised IOSCO Code.[28] Because other jurisdictions (including Japan, Australia and Mexico) enacted regulations on CRAs and several others are in the process of developing regulations for CRAs, CRAs headquartered outside of the EU are now tasked with implementing the complex rules and procedures promulgated in the various territories which may

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[21] Id., art. 4(3)(a).
[22] Id. Art. 5(1)(b).
[23] EU Regulation, art. 5(1).
[24] Id., art. 5(1)(d). *Systemic importance* is not defined in the regulation, but presumably implies the largest CRAs based in the US, Japan and Canada. CESR considered the matter of determining systemic importance an issue for competent authorities of all Member States.
[25] ESMA, *Final Report, Guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation No 1060/2009*, ESMA/2011/139.
[26] Although the head offices, main management teams and main administrative hubs are in the US, they operate in the EU through subsidiaries established in number of European countries. However, Fitch is dual headquartered in the US and the UK.
[27] ANR Sy, *The Systemic Regulation of Credit Rating Agencies and Rated Markets* 24-26m, IMF Working Paper No. WP/09/129, 2009.
[28] See fn 5. The EU Regulation states that CRAs should apply the IOSCO Code of Conduct on a voluntary basis.

not conform to the detailed standards promulgated by the European Commission. In particular, they are required to implement the stricter of any conflicting rules if they wish to issue ratings for use in the host country. This is a significant undertaking as the regulations permeate all aspects of the CRAs' daily operations.

In the event that no CRA were exempted and no regulatory regimes were deemed *equivalent to* or *at least as stringent as* the EU Regulation, only those ratings developed entirely within the EU would have been eligible for regulatory purposes.[29]

An inability to assess third-country CRA regimes as *equivalent* would make lending to or investment in non-EU sovereigns, financial institutions and corporates prohibitively expensive for EU banks and securities firms owing to the material increase in regulatory capital requirements associated with not being able to recognize the relevant ratings. This scenario may be complicated further by the instance, particularly in the Asia-Pacific region, of CRA arrangements whereby lead analysts are located in regional hubs and rate firms and debt issues across several economies. If the EU-based CRAs choose not to, or are unable to, rate securities outside of the EU, the EU financial institutions would not be able to invest in non-EU debt securities. Even if the smaller EU CRAs did rate debt outside of the EU, their ratings may not be viewed as being of sufficient quality and their regulatory use by EU financial firms may raise concerns among other market participants. This could hinder the flow of capital between Europe and non-EU jurisdictions, thus lessening European investment opportunities.[30] It could also impact the ability of foreign governments or companies to raise capital in the EU. This in turn may lead to unintended consequences for the management of liquidity in Europe, increased credit concentration risks across the market and the non-viability of some business models.

The EU Regulation's certification requirement could also have anti-competitive effects, serving as a barrier to entry into the EU market.

The requirement of having a subsidiary or branch in the Community could prevent some third-country CRAs from operating in the Community completely. While many of the US based CRAs have subsidiaries in the EU, two of the largest CRAs in Asia, *Rating and Investment Information, Inc.* and *Japan Credit Rating Agency, Ltd.,* do not currently have subsidiaries in the EU.[31] *Rating and Investment Information, Inc.* primarily assigns ratings on bonds issued in Japan, but it also assigns ratings to bonds issued in the EU markets.[32] Similarly, *Japan Credit Rating Agency, Ltd.* primarily rates corporations and financial institutions in Japan, but those ratings can be utilized by banking institutions in the EU for risk weight assessment. They are both large CRAs likely to be deemed "systemically important" and thus would not be able to use the certification procedure. Instead, these CRAs would have the burden of establishing EU-based subsidiaries to issue these ratings. Such an action may be deemed too costly in relation to the amount of revenue such rating activities would generate, causing CRAs like *Japan Credit Rating Agency*, *Ltd.* or *Rating and Investment Information, Inc.* to withdraw from the Community altogether.

Even for entities not found to be systemically important, many jurisdictions' regulations likely will not be deemed equivalent and ratings issued by these unqualified CRAs would be disbarred, thereby limiting competition within the EU.[33]

The introduction of an elaborate and prescriptive regime for third-country CRAs to be used in the EU for regulatory purposes may lead to a sort of protectionism, making the EU at risk of falling behind the US in

[29] EU Regulation, art. 5.
[30] Letter from Yasuhiro Harada, Chairman and Co-Chief Executive Officer, Rating and Investment Information, Inc., to Jörgen Holmquist, Dir. Gen., Internal Mkt. and Servs., European Comm'n 4 (Sept. 5, 2008).
[31] Letter (fn. 30), at 3.
[32] Letter (fn. 30), at 3.
[33] E Parker and M Bake, *Regulation of Credit Rating Agencies in Europe*, 24 BUTTERWORTHS J. OF INT'L BANKING & FIN. L. 401, 402 (2009).

international awareness.[34] This may to a significant level eliminate the benefits of equivalence as a form of mutual recognition of regulatory standards among countries and, generally, recognition of compliance with global standards.

IV. THE "EQUIVALENCE" REGIME AS A COORDINATING MECHANISM

The following discussion on the EU Regulation and its extraterritorial effects is part of an intense political debate - created by the increased rate and significance of cross-border financial flows across the Atlantic and exacerbated after the financial crisis - over regulatory jurisdiction and extraterritoriality, which focuses on equivalence and mutual recognition[35].

An inescapable implication of the extraterritorial effects of the EU Regulation is that it could lead to overlapping jurisdictions, conflicting legal regimes and, possibly, over-regulation.

Divergent developments in the industry concern, for example, the "issuer website" rules. In US, the Securities Act Rules 17g-2 and 17g-5 have been amended to require NRSROs to disclose more credit rating history information and disclose information relating to an initial rating provided by an issuer to certain non-hired NRSROs. The amended rules also require issuers to provide information to both hired and non-hired NRSROs. Non-US CRAs or branches of US CRAs that are not registered with the SEC as NRSROs are not subject to the regulations. In addition, even in the case of NRSROs regulated by Rule 17g-5, ABS issued by non-US issuers to non-US persons are exempt from the application of the rule until 2 December 2011. In the EU, Article 8 of the amendment to the CRA Regulation EC 1060/2009 proposed that issuers of structured finance instruments (or related third parties) must give non-hired EU CRAs access to the same information they give to the EU CRA they hire to rate the instrument. This was similar to Rule 17g-5 in the US, but was voted down, apparently heavily influenced by the observation that, in the US, the rule did not have the intended effect of generating competitive unsolicited ratings, but had only added to the administrative cost and burden of effecting a securitization. Given these divergent developments on the parallel Rule 17g-5 and Article 8 reforms, it will be interesting to see what coordination action is taken (if any) as between the SEC and ESMA when the exemption for non-US ABS comes to an end on December 2011.

The EU and the US differ also in disciplining CRAs liability. While US CRAs are now subjected to "expert liability", currently the EU CRA Regulation does not establish a specific civil liability regime itself.[36] Investors' claims against CRAs are legally difficult to treat under the predominant issuer-pays model, where investors do not have a contractual relationship with the CRA. Consequently, an investor suffering a loss due to a flawed rating, in breach of the CRA Regulation, cannot base claims for compensation directly on contract law. Whether and under what conditions an investor can claim compensation based on the law of tort varies largely according to the legal orders of Member States.[37] Often, liability of CRAs vis-à-vis investors outside contractual relationships is subject to restrictive conditions, so that in practice investors do not seem to have an effective

[34] The US has appeared more mindful of international constraints in recent times. The Dodd-Frank Act gives rise to fewer problems of extraterritorial application than the Sarbanes-Oxley Act had. Much of the controversy surrounding the extraterritorial effect of Sarbanes-Oxley was related to the new rules of corporate governance and accountability. P Lanois, Between a Rock and a Hard Place: the Sarbanes-Oxley Act and its global impact, 5 J. Int'l L. & Pol. 4 (2007).

[35] The EU has been instrumental in moving the US SEC from a policy of national treatment of non-US issuers to a policy of mutual recognition of financial disclosure regulation based on convergence between US GAAP and international accounting standards (IFRS). RS Karmel, *The EU Challenge to the SEC*, 31 FORDHAM INT'L L.J. 1711 (2008).

[36] Neverthless, Recital 69 of the CRA Regulation states that any claim against a CRA in relation to any infringement of the provisions of this Regulation should be made in accordance with the applicable national law on civil liability.

[37] Differences between Member States' civil liabilities regimes applicable to CRAs lead to different levels of protection for investors and could even incentivize forum shopping whereby CRAs chose jurisdictions where civil liability for infringements of the CRA Regulation is less likely.

right of redress. This is confirmed by the very limited case law in EU Member States on CRAs' civil liability towards investors. Also, the fact that the conditions under which investors can claim damage against CRAs are often either not very clear or left to courts' discretion may in practice prevent investors from claiming damage even in cases of clear infringements and gross negligence.

In general, there are fundamental differences in terms of the philosophy the US has in relation to their regulation and supervision of CRAs[38]. The US approach relies very heavily on upfront and detailed disclosure being made during the application process. Once the information is in the public domain, the US system relies on the SEC and on the ability of the market to exercise its own judgment regarding the credibility of the NRSRO itself, the robustness of the rating processes and procedures and the reliability of the ratings it produces. The SEC has chosen then to make relatively modest changes to the ways in which CRAs operate, favoring the introduction of greater competition for ratings and a scaling back of the use of ratings as a means of regulatory compliance.

However, the two systems are comparable. The goals are the same and, at the end, there appears to be general consensus on the broad parameters of CRA regulation: registration of CRAs with regulatory bodies, disclosure of key rating processes and methodologies, rules governing conflicts of interest.

Furthermore, recent proposals to amend the EU Regulation are more focused on market mechanisms.

Not only an obligation of due care of CRAs towards investors is specified in many requirements of the EU Regulation,[39] but a proposal for a regulation amending the EU Regulation foresees that CRAs should disclose information on their rating methodologies and underlining assumptions, on any proposed changes to their methodologies or on specific information on certain types of credit ratings, such as sovereign ratings.

Small and medium-sized CRAs would be encouraged to exchange information which could facilitate new market entrants entering the rating industry and offer a wide range of services. In addition, comparison of ratings from distinct CRAs could be facilitated by promoting common standards for rating scales and a European Rating Index (EURIX). Furthermore, improved transparency on pricing policies and fees would not only facilitate competition in the rating market, but would also enable ESMA to effectively monitor potential conflicts of interest resulting from the "issuer pays" model. Finally, mandatory rotation of CRAs would not only substantially reduce the familiarity threat to CRA independence resulting from a long business relationship between a CRA and an issuer, but would also have a significant positive effect on improving choice in the rating industry by providing more business opportunities for smaller CRAs.

In both jurisdictions, the level of access enjoyed by investors to information about, from or concerning the CRA and its activities is increasing. With access of the investors to such information, control will be enhanced. The principle of 'stating the reasons' for making a regulatory decision applies now also in the CRAs industry. Stating the reasons will allow shedding light on the deliberative dynamics, and on the arguments at play, and will make the control of CRAs all the more objective.

Because of conflicting regulatory philosophies of national authorities, differing costs of adjusting to foreign regulatory standards and competition among financial centers, traditional unilateral extraterritoriality, whether accidental or intentional, is in the process of changing into a mixture of standardization, exemptions and agreed unilateral or multinational recognition. [40] The approach taken by the EU, during the past decade, in respect to

[38] CESR, *Technical Advice*, 21 May 2010, Ref.: CESR/10-332.

[39] The obligation of a CRA to take all necessary measures to ensure that the information it uses in assigning a credit rating is of sufficient quality (Art. 8 (2) CRA Regulation) or the obligation to monitor and regularly update its credit ratings (Art. 8 (5) CRA Regulation) are obviously in the interest of investors. Breaching these obligations may lead to faulty ratings and could cause damage to investors who have based investment decisions on these ratings.

[40] As far as the U.S. securities law is concerned, the U.S. Supreme Court has recently put limits on its extraterritorial reach: Morrison v. National Australia Bank, June 24, 2010, http:// www.supremecourt.gov/opinions/09pdf/08-1191.pdf. *See*

financial information on securities issuers and accounting standards,[41] in which equivalency focused more on whether the regulatory regime broadly achieved equivalent outcomes, may be used as a template. A flexible approach to equivalency provides foreign market actors *de facto* preferential access to local investors over market actors in non-participating jurisdictions if they comply with foreign regulations that are *comparable* to the local market. If the US system would be deemed equivalent under the EU Regulation on CRAs, such recognition could significantly reduce barriers to capital between the two markets.

As economic theory suggests, where regulators of two large markets negotiate market access, the positive public goods benefits will be equally distributed. Even though the regulator of a small market must adopt standards that are not preferred, and even though adjustment costs are high, access to the EU markets can provide incentives to compromise and adjust. From this perspective, a series of strategic bilateral coordination arrangements by one actor could potentially lead to a global standard, or at least something close to it that is widely adopted by many jurisdictions. By picking off smaller countries and having them converge at its standard, a regulator of a large capital market, such as the EU market, could create network-size advantages that overwhelm the adjustment costs of other regulators. Standards can thus converge with those of the larger regulator.

Equivalence is, at least potentially, a highly coercive instrument. However, it could significantly - perhaps even radically - liberalize markets, depending on the standards required of foreign regulators to be deemed *comparable*. Comparability is a process that could involve considerable domestic regulatory reform and presupposes a sufficient degree of confidence in the effectiveness of each other supervisory systems. It implies a thorough analysis of each other regulatory framework and the common assessment of a sufficient if not high degree of equivalence. Where comparability can be demonstrated, mutual recognition and equivalence offer the benefit of operating not as an exclusionary tool, but as a coordinating mechanism by synchronizing the existing national and regional regulations and developing common approaches.

V. THE EU REGULATORY EXPORT AND THE "HARDENING" OF GLOBAL STANDARDS

The EU Regulation does not seem to have deterred market entry. So far, 23 CRAs have submitted an application for a license with ESMA. In October 2011 all European entities of Fitch, Moody's and S&P's were registered under the endorsement regime. That means that the "Big Three" (that already had subsidiaries in the EU) demonstrated to the EU regulator that the ratings they issue in third countries fulfill requirements that are at least *as stringent as* the requirements set out in the Regulation.

In implementing the EU Regulation, any potential extraterritorial and anti-competitive effects of the Regulation seems to be substantially reduced: the EU has already adopted – or it is in the process of adopting - equivalency decisions without forcing countries to implement the Regulation in full.

In 2009 CESR (as ESMA's predecessor) has been mandated by the European Commission to review the equivalence of various countries, including Australia, Canada, Japan and the US, and it has been carrying out some initial work on a further number of jurisdictions such as Hong Kong and Singapore.

By November 2011, the EU Commission only adopted an equivalence decision concerning the Japanese framework for CRAs. It did not adopt any decision with respect to the US framework. However, several other

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generally E Reuveni, *Extraterritoriality as Standing: A Standing Theory of the Extraterritorial Application of the Securities Laws*, 43 UC DAVIS L. REV. 1071 (2010); XLA Licht and JI Siegel, *What Makes the Bonding Stick?: A Natural Experiment Involving the Supreme Court and Cross-Listed Firms* (Harv. Bus. School Working Paper 11-072, 2011).

[41] In 2008 the EU deemed the GAAP of the US, Canada and Japan equivalent to its IFRS, despite some major differences. Council Directive 2008/961, *Commission Decision of 12 December 2008 on the Use By Third Countries' Issuers of Securities of Certain Third Country's National Accounting Standards and International Financial Reporting Standards to Prepare Their Consolidated Financial Statements*, 2008 O.J. (L 340) 112 (EC).

third-countries were in advanced state of aligning their regulatory framework to the requirements of the CRA Regulation. A transitional period was granted, then, until 30 April 2012. This transitional period allowed market participants to continue using credit ratings issued in third countries, while the convergence assessment with the CRA Regulation requirements continued.

According to its advice on the equivalence between the US and EU regulatory regimes,[42] CESR identified certain weaknesses in the US regulatory regime, mainly relating to the methodologies used, the quality of ratings and disclosure requirements. However, despite the significance EU regulators place on these provisions and the fact that the US prohibits regulators from interfering with the substance of ratings, CESR's analysis is that the two regimes are broadly equivalent in achieving the overall objective of ensuring "that users of ratings in the EU would benefit from equivalent protections in terms of the CRA's integrity, transparency, good governance and reliability of the credit rating activities." Because the US regulations are essentially designed to achieve the same ultimate goals as the EU Regulation, CESR deem them equivalent to the EU Regulation despite differences in the means used to achieve those goals, as was the case when the EU made prior equivalency determinations regarding financial reporting standards.[43] While no formal equivalence decision has yet been taken, ESMA is monitoring the improvements to the legislation anticipated by the Dodd-Frank Act and will continue its assessment as the draft secondary legislation is disclosed by the SEC.

In Japan, the Revised Financial Instruments and Exchange Act of 2010 introduced a registration system for CRAs and the Revised Cabinet Office Ordinance of 2009 prescribes obligations regarding quality control in the rating process. CESR pointed out that it considers the Japanese legal and supervisory framework for CRAs very comprehensive and in many respects similar to that of the EU Regulation. There are no areas where the Japanese requirements did not meet the objectives of the EU requirements and as such CESR had no recommendations to make in respect of the regime as a whole for the purposes of an equivalence determination. The European Commission has identified Japan's regulatory regime as equivalent through a formal decision in September 2010.

Work is continuing on the regimes of Canada, Australia, Hong Kong and Singapore.

In an effort to appease European regulators, the Canadian Securities Administrators (CSA) are planning to regulate hardly CRAs. The latest version of its rules, published for comment on March 2011, introduces a new oversight regime for CRAs. In the original version regulators were taking a "comply or explain" approach, requiring agencies to comply with a code of conduct, or explain why they are deviating from that code. Now, the CSA is dropping the "explain" option; instead, firms must simply comply. The CSA indicated that it is requiring compliance because the CESR had determined that the proposed Canadian approach would not be considered equivalent to the EU Regulation. The failure to obtain an equivalency determination from the European Commission, and the consequent inability of a CRA that issues ratings out of Canada to rely on the endorsement or certification models, would have a negative impact on such CRA. The issuers that such agencies rate might also be negatively impacted to the extent those ratings are used for regulatory purposes in the EU. Consequently, the CSA is proposing to require compliance with a code of conduct that incorporates a list of provisions set out in the rule (which are based substantially on the IOSCO code and have been augmented to meet developing international standards).

Since June 2011 the Hong Kong Securities and Futures Commission (SFC) licenses and regulates CRAs pursuant to amendments to the Securities and Futures Ordinance. The Commission has also adopted a Code of

[42] CESR Technical Advice to European Commission on the equivalence between U.S. regulatory and supervisory framework and EU regulatory regime for credit rating agencies (21 April 2010).

[43] Council Directive 2008/961, Commission Decision of 12 December 2008 on the Use By Third Countries' Issuers of Securities of Certain Third Country's National Accounting Standards and International Financial Reporting Standards to Prepare Their Consolidated Financial Statements, 2008 O.J. (L 340) 112 (EC) (deeming the US and Japanese GAAP equivalent to the EU's IFRS despite significant differences).

Conduct for persons providing credit ratings. Among other things, the Code provides that a CRA should implement and enforce procedures to document reporting lines and allocate functions and responsibilities and ensure that the credit ratings it prepares are based on a thorough analysis of all relevant information known to the agency. In addition, rating methodologies should be rigorous, systematic and, where possible, result in ratings that can be subjected to objective validation based on historical experience, including back-testing. The regulation of CRAs will bring Hong Kong's regulatory regime in line with international developments in this area. Hong Kong is the base from which major multinational CRAs conduct business in the Asia Pacific region. Some smaller CRAs also have offices in Hong Kong.

ESMA has adopted a flexible approach to assessing equivalence of any third country regulatory regime, at least in the early stages of the new regime. Instead of a "plain" equivalence assessment, specific case-by-case review of compliance with EU standards has been required. This would have the benefit of ensuring that major jurisdictions could be considered equivalent from the beginning, whilst recognizing, though, that further work will need to be undertaken. This approach would avoid potential market disruption or distortions arising from the authorities' implement inability to complete the work necessary by the deadline due to insufficient resource available.

There are some early indications that the equivalence regime has been used by the EU to press for changes to countries that host strong financial centers with a heavy international aspect (like the US, Japanese and Canadian rating regime) in a *race to the top*.

We doubt, at least in the case of CRAs, that the inevitable competition in a world of several financial centers creates a regulatory race to the bottom and to the under-enforcement of established regulations.[44] To the extent to which it has authority, the EU can be an important and indeed decisive player in the international regulatory arena, enhancing international convergence in the CRAs industry and promoting mutual recognition of substantively similar regimes. The EU Regulation can be characterized as part of more ambitious plan by the EU to "lead by example"[45] in an attempt to position itself at the vanguard of "an emerging, rules-based, global order"[46] of which it is the author.

VI. A MULTI-MODE GOVERNANCE STRUCTURE

We explored the possibilities of extraterritoriality as a regulatory strategy in the credit rating industry, specifically looking at equivalence clauses used to export the EU regulatory model. Is there a role also for the CRA-industry private sector governance in building and "hardening" global standards in the industry?

Financial governance, in Europe and beyond, is increasingly influenced by multilevel decision-making in private and public, national and international governance institutions. Regulating the activity of CRAs "very much highlights the multi-level governance of financial services and the 'uploading', 'downloading' and 'cross-loading' of rules across jurisdictions and levels of governance"[47].

The public-private dynamics, increased by the interplay between various levels of governance, are complex.

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[44] RS Karmel and CR Kelly, *The Hardening of Soft Law in Securities Regulation*, Brook. J. Int'l L., Vol. 34:3, 883 (2008-2009).

[45] J Barroso, "Leading by Example: The EU and Global Governance" (Speech by President of the European Commission, 12 May 2009, Brussels).

[46] Ibid.

[47] L Quaglia, The Politics of Regulating Credit Rating Agencies in the European Union, The Centre for Global Political Economy WP 5/2009.

At the international level, the CRAs' activity has been regulated by the IOSCO Code, the rules of which have been downloaded, to a large extent, into the EU legislation and, partly, into the Dodd Frank Act. Mostly important, the guidelines adopted by the heads of governments representing the G-20 group of systemically important economies have been implemented by worldwide, regional, national and non-governmental organizations cooperating in the contest of international organizations.

At regional level, extraterritorial effects are evident not only in the EU Regulation (as discussed in the article), but also in the Dodd Frank Act. E.g., *Section 929P* of the Act gives federal district courts jurisdiction over enforcement actions by the SEC alleging violations on the part of CRAs, even if the conduct occurs outside the US and involves foreign investors, as long as the former includes "significant steps" within the US, or has a "foreseeable substantial effect" within the US.[48] In a report released in August 2010, the SEC stated that CRAs should expect that the former would pursue enforcement action against extraterritorial misconduct.[49] This in turn raises issues about the extraterritorial effects of US rules for CRAs operating in Europe and the prospect of an indirect downloading (or cross-loading) of such rules in the EU. These extraterritorial effects of both the EU and US regulation on CRAs raise the prospect of an indirect uploading or cross-loading of the new EU and US rules in, respectively, non-EU jurisdictions" and non-US jurisdictions[50].

Market initiatives such as the CRAs own Code of Conduct – which can supplement and complement incomplete, intergovernmental regulations - may add complexity to the regulatory framework.

CRAs produced regulations of global relevance and application. These are an important source of discipline. The IOSCO Code has served as an industry code and promoted the establishment of internal CRA policies and procedures to give effect to the IOSCO Principles. The mechanisms for implementing the IOSCO Code took the form of any combination of, among other things, government regulation, industry codes and internal CRA policies and procedures. The new government regulation in place can provide a mechanism for implementing the principles in combination with the IOSCO Code. A number of CRAs (including the three largest ones) were found to have substantially implemented the IOSCO Code. A somewhat larger group of CRAs had partially implemented the IOSCO Code.[51] In addition, recent voluntary initiatives have been undertaken by the major CRAs to enhance rating quality.[52]

Also, the IOSCO evaluation of CRA regulatory programs across different jurisdictions (Australia, EU, Japan, Mexico and US) reveals that while the structure and specific provisions of those programs may differ, the objectives of the four IOSCO Principles[53] – quality and integrity of the ratings process, management of conflicts, transparency and treatment of confidential information – are embedded into each of the programs, albeit in varying degrees of implementation.[54] Despite the differences among the jurisdictions, in each jurisdiction reviewed the Principles appear to be the building blocks upon which CRA regulatory programs have been constructed.

Both the Dodd-Frank Act and the EU Regulation encompass - broadly speaking - comparable measures to address three similar objectives. *First*, a lack of competition among CRAs shall be cured by installing a

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[48] Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No 111-203, § 929P(b)(1), (2) (2010).

[49] SEC, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Moody's Investors Service, Inc., Exchange Act Release No. 62802 (2010).

[50] Quaglia (fn 47).

[51] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD233.pdf.

[52] Commission Staff Working Paper, Impact Assessment, at http://ec.europa.eu/internal_market/securities/docs/agencies/SEC_2011_1354_en.pdf

[53] *IOSCO Principles* fn 5.

[54] Report on the *Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies*, February 2011.

registration system with lowered premises to become a recorded organization. *Second*, formerly missing transparency shall be established by extensive disclosure obligations. *Third*, investor protection shall be strengthened through maintenance of objectivity of CRAs by avoiding conflicts of interest. Measures taken to achieve these objectives are essentially well known from the IOSCO Code. The Dodd-Frank Act as well as the EU Regulation only transfer already voluntarily applied provisions into binding regulations which reasonable acting CRAs have already followed voluntarily.

Regrettably, with the move to more intensive regulation, market discipline has been largely avoided in the EU Regulation.

Minimum harmonization and optionality appear to be in permanent retreat in the new regime. E.g., the EU Regulation does not envisage admissibility of a dual system of compliance with its requirements, whereby local/regulatory duties in a third country would be "topped up" by policies and procedures voluntarily followed by the third-country CRA or the EU-registered, endorsing CRA. In fact, the requirements *as stringent as* those set out in Articles 6 to 12 may only be established in law or regulation of that third country in order to satisfy the condition laid down in Article 4(3)(b). The EU regulation does not provide any exceptions for such a situation. The reasoning is that "if the requirements for endorsement could be established on a voluntary basis, the risk of non-compliance by the third-country CRA would be significantly higher"[55].

It seems unfair to bar the use of credit ratings in the EU if they are issued by non-EU CRAs who are otherwise in compliance with all provisions in the EU Regulation. It would have been wise to consider the possibility for the endorsing CRA to confirm to EU authorities that the non-EU CRA has met the requirements on a self-imposed basis if there was no equivalent local regulatory regime. This is what the EU Regulation provided just for the eighteen month transition period until June 7, 2011.[56] After that date, the CRAs without an exemption and whose home regulatory regimes are not deemed *equivalent to* or *as stringent as* the EU Regulation have to establish and register a subsidiary within the EU and conduct all rating activities for use in the EU through that entity.[57]

While this move in "regulatory paradigm" in the EU Regulation is an understandable reaction to the financial crisis, it must not be forgotten that the regulatory process more and more infiltrates in the private law domain and enhances the role of private actors in the process of financial markets regulation. The strengths of a market-based approach, which is sufficiently flexible to accommodate changing market circumstances, are particularly important in a sector which is renowned for innovation.[58]

The problem was not self-regulation *per se*, but the failure to integrate structures of private governance of CRAs effectively within a larger institutional setting. While monitoring by reputation can be less effective in an uncompetitive dimension,[59] the reputational `incentive *does* exist. Rather, it is sacrificed as a tradeoff with regulation-induced incentives.

A successful reform of the credit rating industry must be accompanied by the withdrawal of rating-based regulations. When the CRAs will abandon their quasi-governmental function, contenting themselves with their position as private-sector entities, market forces are expected to play their disciplining role and CRAs' revenues will directly relate to the substantive value of their credit ratings and not to any 'regulatory privilege'. Investors

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[55] CESR, Consultation Paper, Para. 94-95.
[56] EU Regulation, art. 41.
[57] Id., art. 5.
[58] RS Karmel and C Kelly, 'The Hardening of Soft Law in Securities Regulation', 34 Brooklyn Journal of International Law 883 (2009), at 885 (noting that soft law is relied upon 'because of the need for speed, flexibility and expertise in dealing with fast-breaking developments in capital markets').
[59] For an extreme chastising view, F Partnoy, The Paradox of Credit Ratings, Univ. of San Diego School Law. Law & Economics. Research Paper no. 20, 2021 (2001), 658, according to which "the reputational capital view of CRAs is not supported by history or economic analysis".

would then be required to make credit judgments of their own. The interplay of market forces by way of more informed investor decision-making may sanction inappropriate or suboptimal behavior by CRAs and incentivize them to alter their conduct. The CRAs are not the only source of creditworthiness information. Above all, the bond market is largely an institutional market, where bond managers at financial institutions – not retail investors – make the buy and sell decisions. Improved disclosure by issuers to investors will facilitate the build-up of capabilities at banks, investment managers and institutional investors to conduct their own assessment of the creditworthiness of the financial products they invest in and thus enhance their ability to avoid mechanistic reliance on CRA ratings. While it may take a number of years for market participants to develop enhanced risk management capability so as to enable reduced reliance on CRAs, authorities should take actions to incentivize the necessary enhancements to be made.

Following failures of ratings in the US subprime mortgage-based securities market, work has been undertaken to reduce regulatory reliance on credit ratings. At the global level, the Financial Stability Board (FSB) reviewed this issue and drew up principles to reduce reliance on credit ratings in standards, laws and regulations.[60] The FSB principles aim to catalyze a significant change in existing practices, to end mechanistic reliance by market participants and establish stronger internal credit risk assessment practices instead.

Some jurisdictions have already implemented or are considering actions to remove or replace references to CRA ratings in their laws and regulations. The US Dodd-Frank Act marks a turning point by requiring the complete removal of regulatory references to credit ratings.[61] In the EU, the proposals for a new Capital Requirement Directive[62] and other proposals[63], reduce the number of references to external ratings and require financial institutions to do their own due diligence.

However, reducing regulatory reliance is proving difficult at times, not least because it complicates the adoption of global supervisory standards such as Basel III that do refer to ratings. It may take a number of years for market participants to develop enhanced risk management capability to enable reduced reliance on CRAs. In the short term, we need institutional safeguards for holding CRAs legally and democratically accountable.

In light of the cross-border activities of certain CRAs and the global nature of ratings generally, the most effective way to minimize potential regulatory gaps and address the regulatory frictions resulting from different regulatory regimes and levels of governance in the CRAs industry is through international coordination and bilateral dialogues.[64] It is important that the US and EU continue to work together to ensure that equivalence determinations for CRAs follow an outcomes-based assessment rather than requiring an exact duplication of rules.

This dialogue should be soon guided to ensure CRAs regulation is globally consistent. The reforms of the US regulatory system, which still represents the largest and most liquid market in the world, on one hand, and of the EU regulatory system, on the other hand, are a critical component of a more effective global system, but in and of themselves they will not be sufficient to create such a system. Increased participation of China, India and the

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[60] Financial Stability Board, *Principles for Reducing Reliance on CRA Ratings*. Those principles were endorsed by the G-20 Seoul Summit in November 2010.

[61] US *Dodd-Frank Act of 2010*, Sec. 939-939A.

[62] COM (2011) 453 final (July 2011), which replaces the current Capital Requirements Directives (2006/48 and 2006/49).

[63] Commission proposal of 15 November 2011 for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings of collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of the excessive reliance on credit ratings, COM(2011) xxx final; Commission Proposal of 15 November 2011 for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies.

[64] KL Casey, Comm'r U.S. SEC, Testimony Concerning International Cooperation to Modernize Financial Regulation, Before the U.S. S. Banking Subcomm. on Sec. and Int'l Trade and Fin. (Sept. 30, 2009).

emerging Middle Eastern financial centers in the debate is critical for success in achieving an international regulatory system that supports the goals of market integrity and investor protection.

The interplay between domestic and global level is a core element to develop and "harden" global standards and to monitor compliance with the G-20 agenda. The IOSCO provides a forum for CRA regulators and supervisors, aiming to help them in enhancing international regulatory and supervisory cooperation in the implementation of their respective jurisdictions' programs, as well as in addressing potential conflicts that may arise from the different regulatory requirements imposed by different jurisdictions upon globally operating CRAs.

These informal, *ad hoc* activities stretch the boundaries of permissible sovereign activity in reciprocal ways. If all regulators share information with each other, then each regulator simultaneously cedes sovereignty in a manner that is evenhanded.

What informal arrangements fail to address is the enforcement issue. The potential for multiple layers of enforcement exists, with 50 states in the US and 28 Member States in the EU. In the building of a cross-border regulatory system on CRAs, equivalence assessments should consider the differences in enforcement, which vary widely across markets. The multiplicity of supervisors involved gives rise to an unworkable patchwork of legal risks, complexities and compliance costs for CRAs that could threaten their viability.[65] Due to the specific nature of the rating activity, in which the division lines between geographical competences of supervisors are not set too firmly, the risk of conflicts over competences may lead to ineffective and/or inefficient supervision, regulatory arbitrage or unlevel playing field.

Can regional supervisors cope with the global dimension of CRAs? Competent authorities may perceive the dimension of CRA supervision mainly from a regional perspective missing a full picture of the global nature and impact of a CRA's activity. Especially in situations where the main impact of a CRA lies outside the jurisdiction where it is registered, there is the risk that the regional competent authority does not allocate sufficient resources for the supervision of this CRA. The competent supervisor, which is used to being responsible for its regional financial market and accountable to its national political institutions, has to take the main responsibility for CRA activities with global reach affecting primarily financial markets outside its home jurisdiction.

To promote transatlantic coordination, consistent enforcement of the regulatory standards within a jurisdiction and accord with the broad nature and impact of CRAs activities, responsibility for enforcing regulatory laws and rules applicable to CRAs should be vested exclusively at the highest governmental level within a jurisdiction. Perhaps most notably for the EU financial market is the centralization of licensing, supervisory and enforcement powers over CRAs in a central EU authority, the European Securities and Markets Authority (ESMA). The traditional distinction between the home competent authority and the other competent authorities and the use of supervisory coordination by colleges is no longer necessary. The possibility of sanctioning CRAs is not a substitute for an efficient right of redress for investors (sanctions imposed in the public interest do not compensate investors for their losses). However, the ESMA "rule-making" and supervisory powers over CRAs and local supervisory authorities are of potentially dramatic significance to the EU financial market regulation.

Within the proposed 'constitutional framework', based on reducing regulatory reliance on CRAs, enhanced CRAs accountability and cooperation amongst regulatory entities, constitutional pluralism does not represent an academic utopia.

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[65] Despite the Reform Act's framework for exclusive federal regulation of NRSROs, the New York and Connecticut attorneys general have sought to impose far-reaching reforms on the three largest CRAs using actual or threatened litigation under state law.

VII. CONCLUSIONS

In analyzing the EU Regulation on CRAs and its extraterritorial effects, this chapter addresses conceptual challenges for contemporary financial regulation and supervision based on the idea of imposing higher regulatory standards via extraterritoriality.

The financial crisis has dealt a serious blow to previously existing international dialogue and the fear exists that the main regulators would withdraw on their national battlefields. However, we found that the equivalence regime introduced by the EU Regulation on CRAs enhance the benefits of equivalence as a form of mutual recognition of regulatory standards among countries and, generally, recognition of compliance with global standards. The extraterritorial effects of the EU Regulation - which is accompanied by robust additional requirements for certification of third-country credit ratings to be used in EU - may then lead to stronger global standards in the industry.

The European Commission, in assessing equivalence of third countries regulatory regimes, adopts a flexible approach, taking into account of the inevitable differences in regulatory philosophy and approach and that an exact replication of all the EU requirements will not be necessary. The process is not limited to a passive finding of equivalence in regulation, but consists of an active search for common or at least compatible solutions. As a result, there are early indications that regulations on CRAs in some major jurisdictions, such as the US, Japan, Canada, Hong Kong and Australia are converging toward the EU regulatory framework.

In this approach to regulation, we tend to be critical of authoritarian *top-down* conceptions of intergovernmental economic regulation and promote, instead, competing liberalization at multiple levels and in multiple modes. Disciplining mechanisms such as territoriality and private-sector governance may render global financial standards more coercive than traditional theories of international law predict. The literature that dismisses international financial rules on the basis of their legal informality should not overlook the context in which the rules operate.

Postscript

Since this article has been written, the European Commission published an equivalence decision on Argentina, Brazil, Mexico, Hong Kong and Singapore, concluding that their legal and supervisory framework for CRAs are equivalent to the EU regulatory regime for CRAs. In addition, amendments were made in the EU to the CRAs Regulation, which entered into force in 2013. Among others, the new rules will make CRAs more accountable for their actions, ensuring that a CRA can be held liable in case it infringes intentionally or with gross negligence the CRAs Regulation, thereby causing damage to an investor or an issuer. Following these amendments, the EU and the US will not differ substantially in disciplining CRAs liability.

These new events indicate that regulations on CRAs in some major jurisdictions are converging toward the EU regulatory framework. This is consistent and even supports the approach to regulate CRAs we adopted in this chapter, whose purpose was to explore the prospects of harmonization and the development of global standards in the CRAs industry via extraterritoriality.