

Contents

1	Introduction	1
1.1	Aim	1
1.2	Need for Credit Rating	1
1.3	Literature Review	2
1.4	Need for Research	3
1.5	Research Questions	3
1.6	Gatekeepers' Role and Accountability	4
1.7	Research Method	5
	1.7.1 Doctrinal Analysis and Black Letter Law	5
1.8	The Research Agenda	6
1.9	Regulation	6
1.10	The Research Boundaries	7
1.11	Book's Contribution to Knowledge	8
1.12	Outline	9
	References	9
2	Theories, Rating Failure and the Subprime Mortgage Crisis	11
2.1	Introduction	11
2.2	Regulatory Models and Theories	12
	2.2.1 The Rationale for Regulation	12
	2.2.2 Various Other Theories	19
2.3	An Introduction to Credit Ratings	24
	2.3.1 Introduction	24
	2.3.2 Moody's and Fitch: Ratings Volume and Revenue Generated	30
	2.3.3 Conclusion	32
2.4	The Subprime Mortgage Crisis	33
	2.4.1 What Is Structured Finance?	33
	2.4.2 What Led to the Crisis?	36
	2.4.3 The Housing Market	36
	2.4.4 Financial Engineering	37

2.4.5	The Role of Investment Bankers	38
2.4.6	Globalisation	39
2.4.7	The Lenders' Role	40
2.4.8	Market Turmoil	41
2.4.9	General Criticisms	44
2.4.10	The Blunder	46
2.4.11	The Credit Crunch	46
2.4.12	The Result of the Crisis	47
2.4.13	The Culprits Blamed for the Crisis	48
2.4.14	Causes and Complexity of the Financial Crisis	48
2.5	The Saga of Enron, Lehman Brothers and Northern Rock	52
2.5.1	Enron's Saga	53
2.5.2	Lehman Brothers	55
2.5.3	The Northern Rock Fiasco	58
2.5.4	Reliance by Investors	60
2.5.5	Conclusion	61
	References	63
3	US and EU Soft Law: Self-Regulation	71
3.1	Introduction	71
3.1.1	What Is Soft Law?	72
3.2	IOSCO Code of Conduct	73
3.2.1	Background	73
3.3	Adoption of the IOSCO Code	76
3.3.1	Introduction	76
3.3.2	Adoption of the IOSCO Principles	77
3.3.3	Conflicts of Interest	78
3.3.4	Quality of the Rating Process	79
3.3.5	Unsolicited Ratings	80
3.3.6	Transparency	81
3.3.7	Expectation Gap	82
3.3.8	Due Diligence	84
3.3.9	Opinion Shopping and Credit Spotting	86
3.3.10	Sanctions	86
3.3.11	Provisional Conclusion	87
3.4	Deficiencies, Sanctions and Conclusion	88
3.4.1	Deficiencies of the IOSCO Code	88
3.4.2	Sanctions for Breaches of the Code	89
3.4.3	Conclusion	89
	References	91
4	US Statutory Regulation	93
4.1	Introduction	93
4.2	Credit Rating Agency Reform Act 2006	93
4.2.1	Introduction	93
4.2.2	Background to Regulation	94

4.2.3	NRSRO as a <i>De Facto</i> Oligopoly	95
4.2.4	Corporate Governance	95
4.2.5	Regulating Credit Rating Agencies	96
4.2.6	Abusive Practices	97
4.2.7	The Need for the Reform Act	98
4.2.8	Nationally Recognized Statistical Rating Organization (NRSRO)	107
4.2.9	Oversight	110
4.2.10	Barriers to Entry	111
4.2.11	Tackling CRAs	112
4.2.12	The Issue of Competition	116
4.2.13	Is There a Better Way of Compensating CRAs?	118
4.2.14	Interim Conclusion	119
4.3	Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank)	120
4.3.1	Introduction	120
4.3.2	Too Big to Fail	121
4.3.3	The NRSRO's Role	121
4.3.4	Gatekeeper Theory Revisited	123
4.3.5	Dodd-Frank's Regulation of CRAs	123
4.3.6	SEC's Studies	135
4.3.7	Expert Liability and Legal Defences	139
4.4	Assessment	141
4.4.1	Public Oversight and Accountability	141
4.4.2	Comments by Others	143
4.4.3	Conclusions	144
	References	145
5	EU Statutory Regulation	151
5.1	Introduction	151
5.2	Need for Statutory Regulation	152
5.2.1	Inadequacy of the Pre-existing Regulations in the EU	152
5.3	Salient Features of the Regulation	154
5.3.1	Distinction Between Solicited/Unsolicited Ratings	154
5.3.2	Methodologies	155
5.3.3	Competition	155
5.3.4	Assessment	156
5.3.5	Disclosure of Information and Due Diligence	156
5.4	Regulation Dealing with Conflicts of Interest	157
5.4.1	Rating and Consultancy	158
5.4.2	Managing Conflicts of Interest	158
5.4.3	Independence	159
5.4.4	Methodologies, Models and Key Assumptions	160
5.4.5	Risk Warning Indication	162
5.4.6	Transparency	162

5.4.7	Raising Awareness for Users	163
5.4.8	Prohibition of Forum Shopping	163
5.4.9	Registration	164
5.4.10	Penalties for Infringing the Provisions of Regulation . . .	164
5.4.11	Rotation of CRAs	166
5.4.12	Who to Blame: Investors or CRAs?	169
5.4.13	Reducing Reliance on Ratings	170
5.5	Ethos of Regulations	171
5.5.1	Regulatory Convergence	171
5.5.2	The Applicable Law	171
5.5.3	Globalisation: Need for a Level Playing Field	171
5.5.4	Self-Regulation	172
5.6	Quality Credit Rating	172
5.6.1	Registration	173
5.6.2	Supervision	173
5.6.3	Sovereign Debt Rating	174
5.7	Legal Accountability	174
5.8	Conclusion	177
	References	178
6	US Case Law Regulation	181
6.1	Introduction	181
6.2	Tort Law and Corrective Justice: Compensating Investors	181
6.2.1	Corrective Justice and Distributive Justice	182
6.2.2	Balancing of Interests	183
6.3	Cause of Actions: Options Open to Investors	183
6.3.1	Common Law Fraud in the US	183
6.4	Negligent and Fraudulent Misrepresentation	188
6.4.1	Reasonable Reliance and Disclaimer	188
6.4.2	Third-Party Beneficiary Rule	189
6.5	Drawback to Investors' Lawsuits	191
6.5.1	Motion to Dismiss and Standard of Review	191
6.5.2	Pleading and Liability Standards Under the Reform Act	194
6.6	Liability for False Ratings Statements in Public Registration	195
6.6.1	Pleadings	195
6.6.2	States of Mind in Private Actions: Section 933 of the <i>Dodd-Frank Act</i>	196
6.7	Protection Afforded to CRAs	197
6.7.1	First Amendment Protection of Expressions of Opinion	197
6.7.2	Litigation by Issuers	198
6.7.3	Exceptions to First Amendment Defence	199
6.8	The Protection Afforded by New York Shield Law	204
6.8.1	What Constitutes Journalism Privileges?	205
6.8.2	The Private Securities Litigation Reform Act 1995	207

6.9	Claims by the Issuers	207
6.9.1	Defamation	207
6.10	Breach of Contract and Professional Negligence Claims	208
6.10.1	County of Orange v. McGraw Hill Companies, Inc.	209
6.10.2	Out-of-Court Settlement	209
6.10.3	More Suits Follow	210
6.10.4	Damages Awarded Against CRAs	213
6.11	Contractual and Tortious Liability in England	214
6.11.1	Privity of Contract	214
6.11.2	Third-Party Beneficiary Rule	215
6.12	Tort Liability	216
6.12.1	Caparo and CRAs	217
6.13	Duty of Care in Australia: <i>Bathurst</i> Case	219
6.14	Threat of Civil Liability	221
6.15	Professional Indemnity Insurance (PII)	223
6.16	Due Diligence	224
6.17	Liability Conundrum	225
6.18	Conclusion	226
	References	227
7	Regulation: Success or Failure?	231
7.1	Introduction	231
7.2	Regulation: Revisiting the Research Agenda	231
7.3	Reaping Profits Without Risking Capital	232
7.4	Subprime Mortgage Crisis and Structured Financial Products (SFP)	233
7.5	Have Credit Rating Agencies Lost Trust?	234
7.6	Soft Law	235
7.6.1	Self-Regulation	235
7.6.2	Criticisms of Self-Regulation	236
7.6.3	Disclaimer by CRAs	237
7.7	Statutory Regulations	238
7.7.1	NRSRO Registration and Competition Concern	238
7.7.2	Competency and Competition	239
7.8	Reduce Reliance on Ratings	240
7.9	Globalisation and the Convergence of the Regulation	241
7.10	Conflicts of Interest and Independence	241
7.10.1	Conflicts of Interest	241
7.10.2	Independence	242
7.11	Imposition of Liability	242
7.11.1	Breaches of Statutory Duties	242
7.12	Reputational Risk	243
7.13	Investors-Pay Model to Issuers-Pay Model	243
7.14	Recommendations	244
7.14.1	Prevention of Regulatory Failure	245

7.15	Other Related Issues	246
7.15.1	Sovereign Ratings	246
7.15.2	Globalisation	247
7.15.3	Legal Enforcement	247
7.16	Formulation of a New Statutory Liability	248
7.17	Summary of the Key Issues	249
	References	250
	Glossary	253
	Index	263