The regulation of the credit rating industry by command and control in Australia: the inadequacy of market-based mechanisms in the United States

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Abstract

The insufficient regulation of the credit rating industry was a key factor in recent corporate and economic failures, including the Enron scandal and the subprime lending boom and bust in the United States. Specific reforms were enacted to correct the industry’s under-regulation, such as the Credit Rating Agency Reform Act of 2006 and the Dodd-Frank Act of 2010. While these reforms have led to increased government supervision, the regulation of the industry in the United States continues to rely heavily on the market mechanism.

In Australia, the regulation of the industry is characterised by the requirement for credit rating agencies to hold an Australian Financial Services licence. Prior to the global financial crisis, ASIC exempted the industry from this requirement. These exemptions have since been revoked. Although a licensing regime also governs the industry in the United States, the NRSRO status is only voluntary. Given the mandatory nature of the licensing regime in Australia, the regulation of the industry here operates, to a large extent, independently of the market mechanism.

This paper compares the regulatory strategies used in the post-crisis regulation of the industry in Australia and the United States. As the proper regulation of the credit rating industry is crucial to economic stability, this paper investigates whether the principal theoretical framework upon which the industry’s regulation is constructed is appropriately conceived. This paper argues that the theories and strategies that have been employed in the United States may be inadequate to regulate effectively in the interests of those who rely on ratings, and the economy more generally.

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I Introduction
Credit ratings have proliferated in the past few decades.¹ Used by regulators and investors alike, credit ratings impact the cost of finance in the public and private sphere, in both the developed and developing world. The credit rating industry is, as a result, highly successful. However, the subject of credit ratings - their content, industry, consequence, and regulation - has not always received adequate academic or legislative attention.² Despite the international reach and influence of credit ratings, the credit rating industry was, only until recently, egregiously under-regulated in most jurisdictions.

Although credit ratings are highly relevant in the operation and organization of debt and capital markets today, credit ratings were instrumental in the Enron scandal and the subprime lending boom and subsequent bust in the United States.³ They were likewise a key factor in the successful marketing of subprime mortgages within that jurisdiction to the international markets.⁴ The overreliance of national and international regulators on credit ratings in calculating the capital adequacy of investors gave rise to the systemic risk that credit rating downgrades would instigate a liquidity crisis. This was demonstrated not only by the global financial crisis, but also by the regional economic disasters that occurred before⁵ and after.⁶

¹ Credit ratings can be broadly defined as opinions that rate financial instruments or debt according to the creditworthiness of the instrument or debt issuer. These opinions are typically symbolized in alphanumerical form and occasionally followed by positive (+) or negative (-) symbols. Alternative forms of expression include star symbols (★), which are used by Morningstar Credit Ratings.
³ Joseph I Lieberman et al, Rating the Raters: Enron and the Credit Rating Agencies - Hearing before the Committee on Governmental Affairs 2002 (”Rating the Raters: Enron and the Credit Rating Agencies - Hearing before the Committee on Governmental Affairs”).
The credit rating industry has, consequently, come under increasing academic, regulatory, public, and legislative scrutiny in recent years. The post-crisis reform of its regulation has been swift. Specific reforms were enacted, such as the Credit Rating Agency Reform Act of 2006 and the Dodd-Frank Act of 2010. As a result of these reforms, the credit rating industry is now the subject of intense government supervision in several jurisdictions, more so now than ever before. And while comprehensive reforms over the industry’s regulation have already been enacted at both the national and international levels, more appear to be on their way.

This paper compares the regulatory strategies that have been adopted in the post-crisis (namely, post-global financial crisis) reform of the credit rating industry’s regulation in Australia and the United States. Despite the importance of the industry’s regulation, research has generally focused on criticising the industry’s pre-crisis regulation and recommending further reforms without clearly identifying the regulatory strategies that have been employed and the reasons that those strategies have failed. And although the regulation of the credit rating industry has become a topic of increasing debate across several disciplines such as economics, law, and politics, it has yet to be examined from a comparative regulatory or unorthodox (namely, non-neoclassical) economic perspective.

This paper attempts not only to identify the pre- and post-crisis strategies that were employed in Australia and the United States, but also to evaluate their relative effectiveness in promoting economic stability in the post-crisis environment. It describes the history and development of the industry and its regulation (part II) before examining the post-crisis reforms that have been enacted in response to the global financial crisis in each jurisdiction (part III). Through that examination, it identifies the specific tools and strategies that have been employed in those reforms. This paper then evaluates the effectiveness of those strategies in properly regulating the industry to the benefit of consumers and economic stability more generally, in the light of developments within the field of behavioural economics (part IV).

II The history of the industry and development of its regulation

Several sources attribute the publication of the first credit rating and the establishment of the first credit rating agency (CRA) to John Moody in 1900. However, the first credit rating was more likely, according to historians and as corroborated by the broader literature on the subject, developed and published several decades earlier by the Mercantile Agency. The Mercantile Agency was originally a credit reporting agency

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7 A growing number of higher degree by research theses continues to be written on the subject (more than 600 in Australia, more than 200 in the United Kingdom, and more than 800 internationally).
8 These include, for example, the Franken Amendment within the United States. For a brief discussion of the Franken Amendment see John C Coffee Jr, ‘Ratings Reform: The Good, the Bad, and the Ugly’ (2011) 1 Harvard Business Law Review 231, 256.
that reported exclusively on the credit history, known capital, and business associations of business organizations and individuals.\textsuperscript{11}

The credit reports of the Mercantile Agency were highly successful for several reasons. Chief to its success was the difficulty, owing to the lack of cost-efficient transport and telecommunication, in obtaining reliable information on the credit history of credit-seekers.\textsuperscript{12} Credit reporting agencies still exist today and chiefly report on the credit histories of consumers by maintaining a database of consumer credit scores for the benefit of credit-givers such as banks, credit unions, and building societies.\textsuperscript{13} The credit reporting agencies are regulated separately from credit ratings and the credit rating industry in both the United States and Australia.\textsuperscript{14}

Originally objective and quantitative in nature, credit ratings developed from credit reports in order to meet the market’s demand, from regulators and investors for expert commentary on and analysis of the financial creditworthiness of prospective borrowers in the light of the relevant social, economic, and political climate.\textsuperscript{15} Unlike credit reports, credit ratings are highly qualitative, involving (despite their ‘objective posture’) subjective judgment\textsuperscript{16} and speculative analysis of likely outcomes given several numerical, factual, and analytical inputs. Although the general nature of those inputs are usually disclosed, the specific combination, weight, and methodologies that the CRAs used in the credit rating process are proprietary in order to discourage plagiarism (from competitors)\textsuperscript{17} and gaming (from those that they rated).\textsuperscript{18}

The credit rating industry was highly successful. Credit ratings timeously fulfilled the informational and reputational niche that had followed the confidence crisis in the aftermath of the financial panic of 1837 in the United States.\textsuperscript{19} The use of credit ratings proliferated again after the Wall Street Crash of 1929, as the crash incited in the public and in regulators a deep suspicion in the ability of banks and financiers to self-regulate ethically and efficiently.\textsuperscript{20} Post-war economic policy and expansion within the United

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\textsuperscript{11} Ibid.
\textsuperscript{12} Credit reports were originally obtained by social network and letters of recommendation, both of which were unreliable, costly, and slow. James D Norris, above n 10, xv–xiv; Edward N Vose, above n 10, 27.
\textsuperscript{13} For illuminating histories on the origin and development of the credit rating and credit reporting industries, including the factors that contributed to each industry’s success, see Rowena Olegario, above n 10; Edward N Vose, above n 10; James D Norris, above n 10. Modern credit reporting agencies include Veda, Experian Credit Report, Dun and Bradstreet (also known as CheckYourCredit.com.au), and the Tasmanian Collections Service.
\textsuperscript{14} In Australia, they are regulated primarily by Part IIIA of the Privacy Act 1888 (Cth), which incorporates the Privacy Regulations 2013 (Cth) and Privacy (Credit Reporting) Code 2014 (Cth).
\textsuperscript{15} See, eg, Rowena Olegario, above n 10, 10.
\textsuperscript{18} Flandreau, Gaillard and Packer, above n 5.
States, particularly in the development of the transcontinental railroad line, had also increased the demand for credit ratings, as railroad corporations securitized property and debt in order to finance their ventures.21

The Mercantile Agency’s rapid success within the United States allowed for the establishment of international presences by the late 1880s. A Melbourne office was opened in 1887,22 and a Sydney office in 1901.23 However, credit ratings are now ubiquitous in modern finance for additional reasons. Liberal trade and entrepreneurial innovations have facilitated the disintermediation of government and commercial lending, increasing, in turn, the demand for independent sources of information and analysis.24 Moreover, as the banking sector has thrived within mixed capitalist economies and internationally, consortiums of national regulators have themselves come to promote the use of credit ratings for the calculation of bank capital cushions in the name of economic stability.25

Despite the extended history of its use, the regulation of the credit rating industry is a relatively recent phenomenon. Originally, the business of rating and reporting the credit history and creditworthiness of businesses and businesspersons was not directly regulated by government. Instead, the credit rating industry was regulated primarily by market forces, in combination with the private laws of contract and tort as periodically enforced by private plaintiffs.26 Given its strictly factual nature, the credit reporting industry was affected by the risks and potential liabilities in defamation, arising out of the negligent misstatement of the credit histories of businesses and individuals.27

The credit rating industry, on the other hand, was initially governed almost exclusively by the law of contract, as its credit ratings were published in print and available by subscription on that basis.28 Defamation laws remained relevant to a lesser extent, as CRAs progressively highlighted the subjective, speculative, and

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22 Edward N Vose, above n 10, 137.

23 Ibid 162.


26 Madison, above n 17, 177–179; Rowena Olegario, above n 10, 152.

27 Beardsley et al v Tappan [1867] 5 Blatch 491 (10 October 1867; Case No 1189, Circuit Court, SD New York).

28 Subscription-based CRAs rely on subscribers for revenue, and publish their credit ratings to subscribers only. At present, only one notable CRA operates under the subscriber-pays model - Egan-Jones Rating Company. The majority of CRAs, including the three largest (Moody’s, Standard & Poor’s, and Fitch Ratings) operate under the issuer-pays model, where they rely upon sellers of financial products (ie issuers) for revenue. Under this model, issuers approach a CRA requesting and paying for the CRA to rate its product. The issuer-pays model continues to attract heavy criticism from academics owing to the obvious conflict of interest between the rating CRA and the rated customer. See generally John (Xuefeng) Jiang, Mary Harris Stanford and Yuan Xie, ‘Does It Matter Who Pays for Bond Ratings? Historical Evidence’ (2012) 105 Journal of Financial Economics 607.
advisory nature of their credit ratings. Although not always clearly expressed in the literature, it is also highly likely that the early CRAs were established firstly as sole proprietorships, partnerships and, later, as joint-stock companies. Given perpetuity and limited liability, however, the corporation proliferated as the most preferred form with which to do business. CRAs were eventually incorporated as limited liability corporations. Corporate law statutes were, therefore, likely to be the first example of direct government regulation over the credit rating industry.

A Regulatory theories, ideologies, and choice of strategy
Whereas the industry was characteristically under-regulated before, it is now the subject of increased, nationally disparate and, as such, progressively complex regulation. As it operates internationally, the industry has, in the post-crisis environment, been subject to various requirements under disparate regulatory frameworks, drawing from competing legal and regulatory ideologies, operating in different legal and political systems. Although headquartered in the United States, the major CRAs have local presences and operations in many other jurisdictions, including Australia. As such, it is no surprise that different governments have employed different strategies and tools in regulating the industry within their respective jurisdictions.

Choice of regulatory strategy is inevitably influenced by social climate and ideology, given the inherently political nature of regulation. The strategies that have been employed in the regulation of the industry by various governments include command and control, modifications to existing rights and liabilities under contract and tort, incentives-based regulation, and market-contingent regulations. Different governments, operating under different leaderships, tend to exhibit a preference for one strategy over another due to ideological influences. However, the industry is often regulated by a combination of these strategies, which are typically implemented to differing degrees.

Regulatory strategies inevitably vary in effectiveness for a number of reasons. Command and control type regulation typically involves the prescription of minimum standards, the proscription of undesirable behaviour, and the provision of punishment for breach of regulations. Command and control regulations typically have the force of law, and often involve a licensing process specific to the industry or activity to control entry into the regulated activity. Regulators are often empowered, to that end, with rule-making powers. This is the case in several industries within Australia and the

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29. As the Mercantile Agency (later known as R G Dun & Co and variations of that name) was recently found liable in negligence (Gibson v R G Dun) and defamation (Beardsley v Tappan), the CRAs progressively refined their contracts and reoriented the purpose of their credit ratings, claiming that it was nothing more than an ‘aid in determining the advisability of giving credit’ James D Norris, above n 10, 133.
30. This can be inferred from various narratives about the establishment of the Mercantile Agency, and the transfers in ownership that have been documented by the literature. See Baker Library, Harvard Business School, Dun & Bradstreet Corporation Records, 1831-1990 (inclusive); 1850-1950 (bulk): A Finding Aid (April 2010) <http://nrs.harvard.edu/urn-3:HBS.Baker.EAD:bak00123>.
33. Ibid 134.
34. Whereas, for example, ASIC regulates corporations, markets, and the financial services sector, APRA regulates the capital adequacy of banks, credit unions, the insurance industry, a large component of the superannuation industry, and other authorized deposit-taking institutions.
United States, but particularly so in the latter jurisdiction, where federal regulators such as the SEC have the power to introduce additional rules concerning federal securities and trade into the Code of Federal Regulations.

Incentives-based regulations are administered in order to nudge regulated parties towards better behaviour by providing concessions or tax deductions. Given that this strategy involves less government intervention in the economic affairs of the regulated, it tends to be promoted by those who believe that less is more in matters of government. However, incentives-based regulations can have unforeseen but foreseeable consequences. In the United States, the amendment of the federal tax code to discourage golden parachutes in 1993 by promoting employee ownership within the corporation had the unintended effect of rewarding short-termism. The amendment promoted stock-linked, performance-based pay. Coupled with the SEC’s removal of several restrictions on the ability of employee-stockholders to sell, regulations created net incentives for employee-stockholders to produce unsustainable spikes in company performance at the expense of the company’s longer-term interests. This made the value of employee-held stocks rise, rendering their sale highly lucrative. Such was the case in Enron.

Rights and liabilities-based regulations are also directly relevant to the industry’s regulation. Apart from their initial formulation, rights and liabilities-based strategies do not involve direct intervention, and do not incur ongoing cost to government as they generally empower private plaintiffs to enforce the rights they have been prescribed. The industry is, in the United States and Australia, subject to the relevant rights and liabilities prescribed within contract and tort, but also, in both jurisdictions, laws governing misleading and deceptive conduct. These additional rights (of consumers and the general public) and liabilities (of the credit rating industry, but also other industries) were introduced in order to protect consumers and provide relief when businesses mislead them. Although these laws are applicable to financial services in both jurisdictions, they are not as often utilized.

In the post-crisis environment, the strategy that is most commonly used in the industry’s reform has been market-contingent (or ‘market harnessing’) regulations. The defining characteristic of market-contingent regulations is that they rely on the market mechanism for effectiveness. Market-contingent regulations are typically developed through a process of neoclassical economic analysis, and the strategy and

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35 Note, however, that although the credit rating industry is regulated by command and control in Australia, it is not regulated by command and control in the United States.
36 Other examples of federal regulators that have been delegated command and control over particular industries with rule-making powers include the Office of Comptroller of Currency (which supervises national banks, federal savings associations), the Federal Housing Administration (which sets minimum standards and conditions for the housing construction and loan underwriting and lending). An official and complete list of federal government authorities within the United States can be found at http://www.usgovernmentmanual.gov.
37 Robert Baldwin, Martin Cave and Martin Lodge, above n 32.
38 In the two-party political system in the United States, it is closely associated with Republican ideals. To a lesser extent, it is associated with the Liberal party in Australia.
40 The case of Enron is only different in that company executives fraudulently claimed to have over-performed with a view to causing the market value of company stock to rise, rather than having produced unsustainable spikes in performance.
41 Robert Baldwin, Martin Cave and Martin Lodge, above n 32, 134–135.
methodology are highly influential within the United States. Examples of this strategy in action includes aviation competition laws, local authority refuse contracting, and emissions trade. Most relevantly, however, they include disclosure laws, which have proliferated in recent years owing to the theoretical appeal of economism and the democratic appeal of transparency in the administration of government and business. Governments have tended to delegate authority to regulate to non-government, government-sanctioned agencies, such as ASIC and APRA in Australia, and the SEC in the United States. The lack of direct democratic line of accountability renders transparency (and other market-contingent strategies) as the preferable regulatory strategy for these regulatory agencies. As mandatory disclosure regulations require little government intervention and ongoing cost, they are easier to justify than more interventionist strategies, such as command and control.

B Jurisdictionally complex: pre-crisis regulation in the United States

In the United States, legal, economic, and political thought is characterized by a convoluted melange of concepts and theories. Although, for example, economic theory has been highly influential in legal scholarship and regulatory discourse for some time, the preference between ‘freshwater’ and ‘saltwater’ schools of thought within the discipline continue to polarize contemporary debates. The divide between these schools of thought have very recently been substantiated by an empirical analysis of citation networks within the discipline more generally. The regulation of the credit rating industry in the United States is no less complicated and just as contested. It involves a complex interaction between state codes and jurisprudence on the one hand, federal codes and regulatory authorities on the other. It likewise involves a consideration of the regulatory strategies that have been employed at each level, and the potential conflict not only between regulatory strategies, but also the theoretical and ideological justifications behind them.

As the three largest and most influential CRAs are organized as corporations, the law and jurisprudence on the duties and obligations of corporations to their shareholders, and of the liabilities of corporate actors for corporate actions, are directly relevant. In the United States, these laws differ from state to state, as state jurisdiction over corporate law is prescribed by its Federal Constitution. However, as

42 Robert Baldwin, Martin Cave and Martin Lodge, above n 32.
44 This is because of the strength of the contractarian concept of the corporation within the United States. As the Federal Constitution disallows prohibits federal government intervention or regulation over contracts (the ‘contract clause’), the contractarian concept of the corporation favours the regulation of corporations at the state level. Richard A Epstein, ‘Toward a Revitalization of the Contract Clause’ (1984) 51 The University of Chicago Law Review 703; Larry E Ribstein, ‘The Constitutional Conception of the Corporation’ (1995) 4 Supreme Court Economic Review 95. According to Fisch, Congress (federal legislature) ‘...considered adopting a federal corporation law, but instead chose an alternative approach reflected in the federal securities laws ... [i]n part ... driven by a concern that Congress lacked the constitutional authority to regulate the internal affairs of the corporation.’ Jill E Fisch, ‘Leave It to Delaware: Why Congress Should Stay out of Corporate Governance’ (2013) 37 Delaware Journal of Corporate Law 731, 732.
45 United States Constitution, Art I section 10. An official transcript of the constitution is available at National Archives and Records Administration, Transcript of the Constitution of the United States - Official Text <http://www.archives.gov/exhibits/charters/constitution_transcript.html>. The underlying rationale for this prohibition is to prevent rent extraction (from politicians and government officials) by unduly, unfairly, or unconscionably manipulating corporate law in exchange for private, personal, political, or pecuniary gain. See Larry E Ribstein, above n 44, 112–113. The history of corporations in
the CRAs provide specialised commentary on international trade, investment, economic, and political affairs, the regulation of the industry’s principal economic activity also falls within the scope of federal regulations.  

Each of the three major CRAs are incorporated in the state of Delaware. The corporate law of Delaware is codified in its General Corporations Law, and the state has long been recognized as the incorporation capital of the world. This sobriquet is owed to a number of reasons, including the expertise its specialised Courts of Chancery in corporate law, the Court’s shareholder-centric interpretation of the purpose of corporations and the duties of its directors and officers, the director-friendly presumptions raised by the business judgment rule, and the difficulties in rebutting those presumptions as indicated by landmark decisions. Corporate law jurisprudence in Delaware is frequently summarized as tending to promote profit-oriented outcomes for shareholders, even at the expense of other constituencies.  

The regulation of corporations through codification and the provision of civil and sometimes criminal punishment in the event of breach typifies government command and control over the behaviour of corporations and corporate actors. Corporate codes are generally described as an enabling statute that prescribes a default set of replaceable rules with which to operate the corporation. However, as corporate codes have the force of law, tend to prescribe the criteria for entry, the obligations attached to ongoing compliance, and the applicable punishment for contraventions, they can be generally described as command and control type regulation. However, while corporate codes prescribe the duties, rights, liabilities and responsibilities between corporations, corporate actors (directors and officers), and corporate creditors (shareholders and more generally), they do not directly regulate corporate economic activity. The regulation of corporate economic activity is often subject to additional federal regulations in both jurisdictions. Car manufacturers are, for example, subject to federal rules on minimum safety standards and maximum environmental emissions with which each manufactured vehicle must comply, on top of those that regulate the

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46 While federal government is constitutionally prohibited from interfering with contractual relationships, it is vested with the power to regulate interstate commerce and trade - see United States Constitution, Article 1, Section 8, Clause 3.


social aspects of their businesses (such as pension and occupational health and safety).

Thus although the major CRAs are incorporated in Delaware, they are also subject to compulsory federal regulations. While CRAs are fundamentally corporations and are regulated as such according to state laws, inter-state and international state and economic activity falls within the purview of the federal legislature owing to the division of power prescribed by the United States’ federal constitution. Congress, in turn, often establishes and delegates its powers to regulate discrete aspects of interstate trade, or distinct industries, to federal authorities. As there is often an overlap between the jurisdiction, competencies, and mandates of these authorities, the federal regulatory framework within the United States is not only complex, but highly fragmented.

As the credit rating industry ultimately caters to the wider market in both the inter-state and international sense, the CRAs are also affected by federal regulations. The mandatory nature of these federal regulations allow for additional government control over the standards of conduct and disclosure of industries more generally. However, in addition to compulsory state codes and federal regulations, CRAs are also regulated by a voluntary licensing regime. The Nationally Recognized Statistical Ratings Organization (or ‘NRSRO’) designation is administered by the SEC, and has attracted substantial criticism in the post-crisis environment. Commentators have argued that the designation, which is used not only by investors but also by other regulators as a proxy for CRA quality and reputation, constituted a regulatory stamp of approval. Empirical studies have concluded that the use of credit ratings by regulators is unambiguously correlated with a decrease in the quality of credit ratings, contributing to systemic risk. The propriety of the government-regulatory adoption of the designation as a proxy for quality. Partnoy, for example, argues that the use of the designation by other regulators (that is, the use, for regulatory purposes, of the credit ratings of NRSRO-designated CRAs exclusively) encouraged the broader market to attach undue importance to the designation.

Introduced in 1975, the original purpose of the NRSRO designation was to not regulate the industry per se. According to official sources, the original purpose of the designation was to indicate to SEC’s regulatees the CRAs whose credit ratings the SEC would allow regulatees to use in the regulatee calculation of the net capital

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51 A comprehensive list of the federal authorities which have been delegated the power to regulate specific industries within United States can be found at http://www.usgovernmentmanual.gov.
required in order to remain in compliance with SEC rules.\textsuperscript{56} Other federal regulators began to also prescribe NRSRO CRAs as the only CRAs whose credit ratings could be used by regulatees in order to measure compliance with their rules.\textsuperscript{57} However, it was unclear whether any federal regulatory agency had jurisdiction to regulate the industry at all until 2006. Given the SEC’s original purpose, there was no process by which other CRAs could acquire the NRSRO status other than by unilateral SEC action.\textsuperscript{58} The NRSRO designation was given, not earned. The designation did not prescribe designated CRAs with additional duties or obligations, and did not therefore regulate designated CRAs at all. The designation did, however, arguably increase the market demand, profitability, and reputation of the credit ratings of NRSRO-designated CRAs.

C Preservation of the status quo: pre-crisis regulation in Australia
The major CRAs have incorporated subsidiaries in Australia. As such, they are regulated in accordance with the Corporations Act 2001 (Cth). Unlike the United States, corporate law in Australia is federal in nature, owing to a reference of power by the states in 2001. There is, therefore, little significance in the specific state in which each CRA is incorporated, as a uniform set of rules and obligations generally apply whichever state the CRAs may be. Like the state corporate codes of the United States, the Corporations Act controls entry into the corporate market, and prescribes not only civil, but criminal punishment for serious breaches with the Act.

The credit rating industry is also affected by misleading and deceptive conduct laws which are, in Australia and unlike the United States, also federal in nature.\textsuperscript{59} The pre-crisis regulation of the industry, however, is characterized by the general inapplicability of Chapter 7 of the Corporations Act. A central aim of Chapter 7 was to ensure that those who relied on financial advice or bought financial products were adequately informed. Under Chapter 7, section 911A requires those who are in the financial services business (including the sale of financial products, or the giving of advice relating to financial products) to hold the appropriate category of Australian Financial Service license.\textsuperscript{60} However, this requirement was inapplicable to three specific CRAS in the pre-crisis environment, as ASIC had provided Moody’s Investors Service, Standard & Poor’s, and Fitch Ratings\textsuperscript{61} with an exemption from the requirement to hold an AFS licence in accordance with section 911A of the Act.\textsuperscript{62} The exemption was effective from 22 December 2003 to 1 January 2010.

\textsuperscript{56} Securities and Exchange Commission, above n 55.
\textsuperscript{57} See ibid 6, footnote 5, for a list of federal regulations (established and administered by other federal regulators) that relied on credit ratings.
\textsuperscript{58} Standard & Poor’s, for example, received NRSRO status in 1976 although it ‘...did not affirmatively seek that status.’ Kathleen A Corbet, President of Standard & Poor’s, Testimony before the Committee on Banking, Housing, and Urban Affairs, United States Senate Hearing on the Role of Credit Rating Agencies in the Capital Markets 2005 9, (‘Testimony before the Committee on Banking, Housing, and Urban Affairs, United States Senate Hearing on the Role of Credit Rating Agencies in the Capital Markets’).
\textsuperscript{59} Competition and Consumer Act 2010 (Cth), sched 2 (‘Australian Consumer Law’).
\textsuperscript{60} Corporations Act 2001 (Cth), s 911A.
\textsuperscript{61} These three CRAs also hold NRSRO designation and were among the first CRAs to be conferred the status since it was first introduced by the SEC in 1975.
\textsuperscript{62} ASIC Class Order No 03/1093 23 December 2003; Class Order No 05/1230 31 December 2005.
The purpose of the exemption was to provide these CRAs with temporary relief during ASIC’s period of consultation with the public on the appropriate measures with which to licence the industry. The matter of the industry’s licensure was likely brought up by the role that credit ratings played in facilitating the Enron scandal, and the consultation period was arguably extended in the light of the more egregious role that the credit rating industry played in the global financial crisis. Given, however, that the United States remained the principal market to which the industry catered, Australian regulations (more accurately, the lack of regulations, given this exemption) essentially preserved the status quo, doing little to regulate industry within or outside of the jurisdiction. The industry was essentially unregulated in Australia, other than by a general legal framework comprised of corporate and misleading and deceptive conduct laws.

Despite the lack of government regulation over the industry, it continued to rate almost 100% of all public debt in Australia. This was perhaps due to the growth in Australia’s retail and commercial banking sector and the increasing demand for financial products from Australia. The success of the industry more generally given the volume of trade in the international financial markets was also a factor that likely contributed to the credit rating industry’s growth in the jurisdiction. The exemption from the requirement to comply with section 911A, moreover, effectively lowered the cost and risks of business for three specific CRAs, contributing to the competitiveness and profitability of these CRAs at the expense of the ability of other CRAs to enter the Australian market.

Unlike the United States, the industry’s regulation within Australia is not characterised by the jurisdictional tension between state and federal precedence, judicatures, or legislatures. The regulatory framework governing the industry’s pre-crisis regulation in Australia was measurably less complex than the one that operated in the United States. In Australia, the industry was not only governed by a single regulator (ASIC), but also, to a large extent, by clearly identified statutes (the Corporations Act and the Australian Consumer Law Act), all of which operate at the federal level and under the adjudication of the Federal Court of Australia.

In contrast, CRAs are governed in the United States by a federal regulator (SEC), as well as the corporate law code and misleading and deceptive conduct laws and jurisprudence of the respective state in which they are originally incorporated. Even if, for example, a Delaware-based CRA incorporates a subsidiary in a different state, the subsidiary continues to be governed by Delaware’s GCL owing to the doctrine of internal affairs within the United States. Although Delaware is the primary

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65 Official statistics show that the financial sector continues to be the largest contributor to Australia’s national output, above construction and mining exploration. The mining and financial sectors’ contributions continue to grow at a similar rate, whereas construction has decreased (2014–2015) and only marginally increased (2015–2016). See Australian Bureau of Statistics, Australian National Accounts: National Income, Expenditure, and Product (Catalogue No. 5206.0, 2 December 2015), 38.
66 The doctrine of internal affairs requires that, in the name of interstate comity, the corporate law of the original state in which a corporation is incorporated continues to apply to its interstate subsidiaries. However, the doctrine is “...just an understanding, not a crisp constitutional rule...”. See Mark J Roe, ‘Delaware’s Competition’, above n 49, 596–598.
jurisdiction in which the majority of CRAs are incorporated in the United States, there are some contemporary examples of CRAs that have been incorporated elsewhere.67

III The nature of post-crisis reforms

As the global and more recent financial crises have shown, the under-regulation of credit ratings and their overuse by regulators and investors can have dire consequences for national and international economic stability. The role of credit ratings in the Enron scandal, the subprime mortgage boom and bust within the United States, and the proliferation of that boom and bust to the international markets exemplify the systemic risks facilitated by the credit rating industry’s under-regulation in most jurisdictions. This under-regulation encompassed the lack of liability for misleading or negligent credit ratings, the lack of enforceable procedural rules to manage conflicts of interest within the organization, and the absence of any meaningful benchmarks against which each CRA’s performance could be measured.

Comprehensive reforms in the industry’s regulation have been enacted in several jurisdictions. There is relatively little unanimity in the scope, shape, and specifics of these reforms. There is, however, relative unanimity (other than in Australia) in the overall strategies that have been employed, and the methodologies that have been used in formulating those reforms. Reforms, enacted and proposed, tend both to square upon increasing the industry’s transparency,68 improving the competition within it,69 and repealing the legislative rules which, pre-crisis, either prescribed or promoted the use of credit ratings by regulators for regulatory purposes.70 These reforms tend to be market-contingent in nature. Other than in initial government formulation and prescription, reforms of this type involve little ongoing government involvement or cost. The reforms that have been enacted in Australia, however, tend to operate independently of the market mechanism, and stand in stark contrast to the market-contingent reforms that have been enacted in the United States.

A Voluntary designation and market-contingent reforms within the United States

In the United States, specific reforms, such as the Credit Rating Agency Reform Act of 2006 and the Dodd-Frank Act of 2010, were, respectively, enacted in response to Enron’s collapse and the global financial crisis. Whereas the CRARA provided the SEC with the specific authority to regulate the industry,71 the Dodd-Frank Act provided

67 Morning Star Credit Ratings LLC, for example, is a Pennsylvania corporation, whereas A M Best Company is incorporated in New Jersey. See the respective NRSRO forms of each CRA, which are available at each CRA’s website (cross-links are provided on the SEC’s Office of Credit Ratings website).
68 See, eg, Section 932 of the Dodd-Frank Act, which increases the SEC’s powers to examine and supervise the industry.
69 Via the requirement for the SEC to provide a summary report to Congress on the performance of each NRSRO CRA, on top of CRARA requirements to annually examine and report to Congress on the state of competition within the industry, identifying the barriers to entry. See Section 939 of the Dodd-Frank Act.
70 See, eg, Section 939 and 939A of the Dodd-Frank Act, which directs federal regulators to review and, to the furthest extent possible, repeal the regulatory rules which rely on credit ratings.
71 In response to the role of credit ratings in the Enron scandal and the social and political imperative to regulate the CRAs, the SEC requested that Congress delegate it with the power to regulate the industry. Congress passed the Credit Rating Agency Reform Act of 2006 in response to the role of credit ratings in the Enron scandal and at the SEC’s request, section 4 of the CRARA introduced section 15 to the
the SEC with increased powers of supervision and examination. Dodd-Frank further mandated the creation of the Office of Credit Ratings within the SEC, likely in recognition of the growing importance of the regulation of the industry to economic stability and in the operation of the financial markets more generally.\footnote{72}

The SEC is also required by Dodd-Frank to provide an annual report to Congress on the effectiveness of its regulations. And as noted before, in order to promote the competition within the industry, the SEC has progressively clarified the process by which other CRAs can acquire the NRSRO designation. While it was previously a status that was conferred, there is now a distinct process, administered by the SEC, by which other CRAs can apply for the designation. On top of these improvements, NRSRO CRAs are now required, as part of ongoing designation, to disclose not only the number of credit ratings they have produced, but also the accuracy (conversely, the volatility) of the credit ratings that they have assigned.\footnote{73}

Other information that they are required to disclose include the organizational structure, the name of subsidiaries in other jurisdictions, as well as the policies and procedures that have been implemented to manage conflicts of interest and potential abuse of inside information. Most importantly, however, NRSRO CRAs are required to disclose the total and median annual compensation of their credit analysts, the audited financial statements of the CRA (even if the CRA is a private company), and a list of the CRA’s largest clients and the net revenue earned from each client.

In addition to the above, the Dodd-Frank Act has attempted to reduce the regulatory reliance on the credit ratings for regulatory purposes in order to correct the misperception that the credit ratings of NRSRO-designated CRAs are preferred or endorsed by government. Section 939 of the Dodd-Frank Act requires regulators to reassess the necessity of the use of credit ratings within their rules. Regulators have in response repealed most of those rules, and SEC rules now contain only minimal references to credit ratings.\footnote{74}

Although the reforms that have been enacted in the United States appear to improve the operation and integrity of the industry, they are highly contingent on the market mechanism for effectiveness. These reforms can be fairly characterized as market-contingent in nature, given that they are unlikely to generate any change in the industry’s behaviour if not utilized by the market. Increased disclosures, for example, attempt to improve the industry’s behaviour by disclosing the relative performance of the CRAs against one another. Through that disclosure, the market is empowered with more information on the accuracy and reliability of each CRA, enabling them to be discerning between the CRAs, and allowing them to disregard less reliable CRAs. Without the expected market reaction, increased disclosures would not have any discernible effect in regulating CRA behaviour.

There is, moreover, the fact that the NRSRO designation remains voluntary, and that the desirability of the designation is itself affected by market forces. The post-

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\footnote{Exchange Act of 1934, allowing the SEC to implement registration, recordkeeping, financial reporting, and oversight rules with respect to NRSRO CRAs.}
\footnote{Section 932 (p)1(A) of the Dodd-Frank Act.}
\footnote{In other words, NRSRO CRAs are required to provide statistics on the performance of their credit ratings over time.}
crisis regulation of the industry only applies to NRSRO-designated CRAs, and there are less and less incentives for CRAs to acquire the NRSRO status, with regulations progressively attempting to remove the apparent benefits attached to the designation in order to prevent the misperception of NRSRO CRAs as having regulatory authority or favour. These incentives are either being progressively removed by regulators in accordance with post-crisis reforms, or counteracted by the increasingly onerous obligations attached to NRSRO designation, particularly the increased and commercially-sensitive disclosures that are now required. There is no protection over the use of the terms ‘credit rating’ or ‘credit rating agency’. There is no regulatory framework, at either the state, federal, or international level, mandating that any organization claiming to be a CRA or claiming to provide credit ratings acquire the NRSRO designation.

B Command and control: mandatory licensing within Australia
The pre-crisis regulation of the industry in Australia broadly echoed the pre-crisis regulatory regime within the United States. Australia has, however, since adopted a command and control approach towards the industry’s regulation in the post-crisis environment via a mandatory licensing regime, with ASIC’s revocation of the industry’s exemption from the requirement to hold an AFS license. Like other providers of financial products, services, or advice, all CRAs are now required to maintain an Australian Financial Services license appropriate to its target demographic, namely, retail or wholesale. Different requirements and obligations attach to each. To-date, only one minor credit rating agency holds the former, as more onerous obligations and serious consequences follow. The three major CRAs hold a wholesale AFS licence, with the effect that their credit ratings are no longer available to the general public.

As a result of this revocation, the prior written consent of the relevant CRA is now required for issuers of financial securities to disseminate credit ratings in the marketing of financial products. By this requirement, a causal nexus has been established between the CRA and the losses that arise from reliance on its credit ratings in the event of its negligence. A recent case adjudicated before the Federal Court has, consequently, allowed investors to recover against the industry, with the decision being unanimously upheld by the Full Federal Court on appeal. These decisions have not only compensated investors for the harm caused by the industry, but have also, by establishing a clear precedent upon which investors can rely upon in future litigation, operated to discourage the industry from engaging in future conflicts of interest, moral hazardous, and negligent behaviour.

75 Although the terms ‘credit rating’ and ‘credit rating agency’ are not specifically protected by statute in Australia, they fall under the interpretation of a financial service and attract AFS licensure requirements.
76 At present, only one CRA holds a retail licence - Australia Credit Rating Agency.
77 In June 2014, the full Federal Court of Australia unanimously held that Standard & Poor’s misled investors with their AAA-rating of ABN Amro’s Rembrandt notes in ABN Amro v Bathurst Regional Council. Along with the other defendants, the CRA was ordered to pay $20.2 million to investors in damages. With only slight modification, this case affirmed the 2012 decision of Justice Jagot in Bathurst Regional Council v Local Government Financial Services that the CRA had misled or deceived investors as their ratings were, on evidence, false, misleading, or at the very least, the result of gross negligence. For a recent case note analysing both the first instance decision and judgment on appeal, see Aarushi Sahore, ‘ABN Amro Bank NV v Bathurst Regional Council: Credit Rating Agencies and Liability to Investors’ (2015) 37 Sydney Law Review 437.
78 As the deadline to file a special leave to appeal against this decision expired on 4 July 2014, the ruling is final. As of 18 January 2016, neither ABN Amro nor Standard & Poor’s have indicated any
The revocation of the industry's exemption from the requirement to hold an AFS licence has worked to ensure that the industry is sufficiently regulated, properly punished, and investors adequately compensated in the appropriate circumstances. The most crucial aspect of the industry's post-crisis regulation in Australia is the mandatory nature of its licensure under the AFS regime. The mandatory nature of the requirement for the CRAs to hold an AFS licence ensures that Australian regulations are enforceable and therefore effective independently of market forces. This contributes to economic stability, as it ensures that the industry is properly regulated under a clear, enforceable regime that is not dependent on the market forces for either effectiveness or even general applicability. Whereas the reforms that have been enacted in the United States can be rendered inapplicable by rescinding the NRSRO designation, the rescission of AFS licensure would render the continued operation as a CRA in Australia illegal, with serious consequences.

Although the regime governing the industry's regulation in Australia appears to have been effective, and to have produced desirable outcomes for investors, the effective regulation of the industry more generally, remains highly dependent on the effectiveness of applicable regulations within United States. As the United States is the principal market to which the industry caters, the ineffective regulation of the industry there is a substantial impediment to the effectiveness of post-crisis reforms elsewhere. A licensing regime somewhat similar to the AFS licence also governs the industry in the United States, but differs in important aspects. Credit ratings are regulated separately from financial advice, and the CRAs are not considered to be financial advisors or to be providing expert opinions.\textsuperscript{79} The NRSRO designation is, crucially, voluntary, and as such, the market mechanism remains the principal force upon which the industry is regulated in the United States.

\textbf{C The lack of an enforceable international framework}

While the credit rating industry operates internationally, there is no international instrument on the regulation of the CRAs. The international context of the credit rating industry's regulation is therefore characterized by the aspirational and unenforceable efforts of national regulators. This is followed by the increasing reliance on credit ratings within the prudential regulation of financial institutions as promulgated by the Bank for International Settlements. There is also no single international regulator that is responsible for the industry's regulation, and there is no international association (or international collection of national associations) that speaks for or regulating the CRAs collectively. Other international regulators and regulations, such as the Bank for International Settlements, its Financial Stability Board, and the Basel II Accord, have intention to attempt an out-of-time application for special leave to the High Court of Australia. Additionally, the Royal Bank of Scotland (proprietor of ABN Amro) expressed in its 2014 annual report that it did not intend to further appeal the full federal court decision. The 2014 annual report of McGraw-Hill Financial Services (proprietor of S&P) was silent on the issue, further indicating against an application out of time.

\textsuperscript{79} The question of whether credit ratings are expert opinions (which can be regulated by government) or journalistic commentary (deserving of constitutional protection against interference with corporate freedom of speech) remains intensely debated, with investors preferring the former interpretation and CRAs preferring the latter. The Supreme Court of the United States has yet to be faced with the question.
worked only to further the importance and impact of credit ratings in public and private finance.\textsuperscript{80}

There is, however, an international consortium of national regulators (the International Organization of Securities Commissioners, or ‘IOSCO’) who are responsible for the regulation of the CRAs within their respective jurisdictions, among other things. It is important to note that IOSCO instruments and recommendations, whilst desirable, are only voluntary and aspirational in nature. IOSCO is responsible for formulating and maintaining the IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies\textsuperscript{81} and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.\textsuperscript{82} These instruments, however, did little to prevent the Enron scandal or the global financial crisis, despite the fact that regulators attempted to induce the industry’s compliance with IOSCO-formulated standards by requiring compliance as part of ongoing licensure within national frameworks. In the pre-crisis environment in Australia, for example, it was a prerequisite for their section 911A exemption that Moody’s, Standard & Poor’s, and Fitch Ratings complied with IOSCO instruments.\textsuperscript{83}

Apart from revising its Statement of Principles and Code of Conduct Fundamentals, IOSCO has also published several reports recommending the establishment of a supervisory college for internationally active CRAs.\textsuperscript{84} The supervisory college would consist of the regulators of internationally-active CRAs in each jurisdiction. The recommendation for the establishment for a supervisory college attempts to facilitate information-sharing, cooperation and consultation between national CRA regulators. Although a final recommendation was published in December 2012, a supervisory college has yet to be established, and it is unclear whether national regulators intend to do so.

IV Behavioural limits to neoclassical economic methodology

Neoclassical economic theory and methodology remains highly influential in the regulation of the industry and the economy more generally. It emphasises the use mathematical equations in order to predict market behaviour, and assumes that markets are inherently rational and will act to maximize efficiency. Neoclassical


\textsuperscript{83}See ASIC Class Order No 03/1093 23 December 2003; Class Order No 05/1230 31 December 2005.

economics therefore tends to eschew regulatory strategies that involve direct
government intervention, and frequently promote those that rely heavily on the market
mechanism.\textsuperscript{85} It is particularly relevant and influential within the United States. The
use of neoclassical economic theory in formulating reforms in the CRA context in
Australia have not been as pronounced, as exhibited by the command and control of
the industry via the revocation of the class order that exempted the CRAs from AFS
licensure.

There are increasing reasons, practical and theoretical, to reconsider the use
of market-contingent mechanisms (such as increased disclosure and voluntary
licensure) as a regulatory strategy. While the reforms that have been enacted in the
United States are ostensibly desirable, empirically, the effectiveness of purported
improvements in the industry’s transparency, the competition within it, and the
regulatory powers with which to supervise and examine the industry’s performance
have yet to be established.\textsuperscript{86} From a theoretical perspective, an increasing body of
empirical evidence opposes the fundamental assumption inherent in the neoclassical
economic theory.

A key aspect affecting the effectiveness of the regulation of the CRAs arises
from the implications of behavioural economics on the methodological assumptions
underscoring the majority of market-contingent reforms. Behavioural economics
emphasises the importance of psychological insight in the understanding of individual
economic behaviour.\textsuperscript{87} The field of economics more generally has always assumed
that markets are (or ought to be) inherently rational and intrinsically act to maximize
efficiency, and that certain dysfunctions such as information asymmetry can and
should be corrected by government regulation in order to facilitate the market in acting
rationally to maximize efficiency. Behavioural economics studies the potential
implications of findings from cognitive, psychological, and behavioural sciences
(namely, the nature and process of human decision-making) on this assumption.\textsuperscript{88}

Although the field of behavioural economics has had substantial implications in
other fields, it has yet to be fully utilized within the context of CRA regulation.\textsuperscript{89}

\textsuperscript{85} The primary theory within neoclassical economics that is often used to argue against direct
government regulation in favour of market-contingent market regulations is the Coasean theorem. The
theorem was developed from two papers, namely Ronald H Coase, ‘The Problem of Social Cost’ (2013)
386. In short, the Coasean theorem states that the law should not place prescriptions or prohibitions on
market conduct, even in attempt to mitigate or manage the externalities (harm caused to third parties
who do not benefit from the market conduct and are not compensated as such) caused by market
behavior. The law should instead establish a robust system of property rights or incentives, which would
make it more cost-efficient for market participants to optimize behavior and mitigate externalities. Modern examples of this include the introduction of emissions trading schemes and taxes.

\textsuperscript{86} Timothy E Lynch, ‘Deeply Persistently Conflicted: Credit Rating Agencies in the Current Regulatory

\textsuperscript{87} Owing to increased accessibility and decreased cost, the use of algorithmic and high-frequency
trading strategies have proliferated in recent years. However, subjective human knowledge, thought,
and action continue to play an important role in investment decision-making, as not all investment
portfolios, funds, or decisions are completely automated. Decision-making in both investment and credit
ratings likewise continue to involve human psychology, and it is likely that the field of behavioural
economics will become increasingly important in the formulation of public policy and legislation.

\textsuperscript{88} Graham Mallard, \textit{Bounded Rationality and Behavioural Economics} (Routledge, 2015) 1–3.

\textsuperscript{89} It has, however, usefully informed other aspects of consumer and/or financial regulation and has
been used to justify the SEC’s expanding role. See Stephen J Choi and A C Pritchard, ‘Behavioural
Marketing strategies, for example, have been enriched by the findings that decision-makers possess limited cognitive resources that are consumed during acts of decision-making and can suffer from ‘decision fatigue’,\(^\text{90}\) that consumers tend to prefer the choice between fewer options,\(^\text{91}\) and that consumers are easily confused into misperceiving the value of products as higher when the list of attributes of a particular product are artificially increased.\(^\text{92}\) In public policy, opt-out rather than opt-in organ donation systems have seen a rise in participation in organ donation programs, as options that are set as the default are more likely to be chosen.\(^\text{93}\) In political discourse, the framing of environmental policies as a cost to be incurred (eg as a tax) tends to reduce public support for those policies, whereas projecting the potential revenues brought about by those taxes tends to increase support.\(^\text{94}\)

The key insight from behavioural economics relevant to the regulation of the CRAs that has yet to be fully considered is the finding that human rationality is inherently limited. Not only are investors vulnerable, as people, to suffer from decision fatigue,\(^\text{95}\) they are also manifestly irrational in some circumstances as they tend to increase commitment to a particular stance despite being shown its incorrectness.\(^\text{96}\) This irrationality has been observed within financial analysts\(^\text{97}\) despite the lack of a financial incentive for them to either be correct or consistent in their forecasts.\(^\text{98}\) Moreover, investors, as people, tend to prefer to act in accordance with the standard equilibrium (namely, with the market and its perceptions more generally) when pressed for time (as is the case for investors generally, as many investments are time-sensitive).\(^\text{99}\) As such, investors have been observed to sell profitable investments too early, and hold on to losing investments too long.\(^\text{100}\) This has important implications on the effectiveness of market-contingent CRA reforms, as those reforms tend to presuppose the market’s rationality in making full use of the enhanced transparency of the CRAs in the post-crisis environment.

The finding that decision-makers that have limited liability tend to expend less effort in acquiring information than decision-makers that have unlimited liability is particularly relevant to the CRAs.\(^\text{101}\) Moody’s, Standard & Poor’s, and Fitch ratings are all incorporated as limited liability corporations in both Australia and the United States. As their credit ratings purportedly speak to the creditworthiness and credit quality of other entities and financial products, this finding tends to qualify the accuracy of their ratings. More importantly, however, is the fact that credit ratings are free for consumers

\(^{90}\) Graham Mallard, above n 88, 17.
\(^{91}\) Ibid.
\(^{92}\) Ibid 37.
\(^{93}\) Ibid 17.
\(^{94}\) Ibid.
\(^{95}\) Ibid 17–18.
\(^{96}\) Ibid 15.15
\(^{97}\) Although it is not clear whether financial analyst who are employed by CRAs were tested in this experiment, CRAs tend to employ financial analysts and credit ratings often involve the decisions and opinions of financial analysts.
\(^{98}\) Graham Mallard, above n 88, 15–16.
\(^{99}\) Ibid 16.16
\(^{101}\) Graham Mallard, above n 88, 31.
(investors), but not for issuers (sellers of financial products). As investors have limited cognitive resources with which to calculate the cost and benefits of a particular investment, they often rely on rules of thumb (mental shortcuts or ‘heuristics’) when making difficult decisions, particularly those involving risks and probabilities. The general availability and high visibility of credit ratings, at least outside of Australia, means that they tend to be adopted as heuristics in the post-crisis environment, despite the controversy surrounding the industry in the global financial crisis.

It is safe to say that a growing body of empirical studies within the field of behavioural economics has established that there are inherent, cognitive limits in human decision-making. These findings have important implications for the regulatory preference for neoclassical economic methodology and the fundamental assumption of human (and, by extension, market) rationality. While choice of regulatory strategy is inevitably influenced by local political climate, ideological preference, and socioeconomic context, it is important in the light of these findings to qualify the use, or at least reconsider the justifications and propriety, of economism in the formulation of regulations which rely on the market mechanism for effectiveness. Although neoclassical economic theory and analysis remain the principal conceptual and theoretical frameworks governing the industry’s regulation, particularly in the United States, it may no longer be appropriate for these purposes.

V Conclusion

As it has done so before, it is likely that the credit rating industry will continue to grow “despite the law, against the minds of judges, and beyond the boundaries of [existing regulations].” Experience, both in the recent (the Enron scandal, global financial crisis, and the Eurozone crisis) and distant (Financial Panic of 1837, Wall Street Crash of 1929) past, have clearly shown that the financial markets cannot self-regulate with the public’s interest in mind, given that market participants inevitably pursue their own self-interests even at the expense of economic stability. It is therefore no longer proper “…to listen to the siren song of self-regulation and to delay or weaken [regulatory responses] to the crisis.”

Owing to the invalidity of the methodological assumptions and theoretical justifications which underscore those strategies, the regulation of the credit rating industry in the United States is inherently flawed. These flaws have consequences on the practical effectiveness of the regulatory strategies which have already been there employed. The heavy reliance on the market mechanism in the regulation of the industry may no longer be appropriate or effective to the extent once thought, as an

102 Ibid 4.
103 Anecdotal evidence that credit ratings continue to be used as heuristics include the fact that the revenue of Moody’s, Standard & Poor’s, and Fitch Ratings has continued to increase despite the repeal of regulations which encouraged reliance on credit ratings. As credit ratings are paid for by issuers, the increase in CRA revenue can be attributed to the issuer perception that investors continue to rely on credit ratings as an important source of information and investment decision-making.
increasing body of evidence contradicts the methodological assumptions inherent in the market-contingent regulatory strategies. These contradictions have potential implications not only for the effectiveness of the strategies in the regulation of the industry, but in the regulation of the economy more generally.

The Australian approach towards the credit rating industry’s post-crisis regulation operates, in contrast, largely independently of the market mechanism and the methodological assumptions which underscore the industry’s regulation in the United States. Through a mandatory licensing regime, Australian regulations allow for government command and control over the perimeters of acceptable and prohibited conduct within the industry. The overall findings of this paper suggest that enhanced government command and control over the industry is not only justified, but necessary to promote economic stability, as the methodological assumptions of market-contingent regulatory strategies do not sufficiently correspond with reality.

Despite both the lack of evidence of effectiveness and the questionable nature of the theoretical justifications of market-contingent reforms within the United States, proposals for the industry’s further reform (in the United States and elsewhere) continue to be market-contingent for effectiveness. Given the inherent cognitive limits on human rationality and the market’s behaviour, the practical effectiveness of these proposals remain highly suspect and should not be taken for granted. The growing body of empirical evidence contradicting the market rationality assumed by neoclassical economic analysis supports the conclusion that neoclassical economic theories may no longer be appropriate for the design of the industry’s regulation. And without substantial qualifications to the fundamental assumptions of neoclassical economic theory, market-contingent regulations may not be appropriate for the economy more generally.

The overall findings of this paper suggests that the reliance on the market mechanism to regulate the industry is ineffective to the point that they are impermissible. Reliance on the market mechanism is ineffective as the expected benefits of such reforms can only be felt if markets are sufficiently diligent and disposed to make use of increased disclosures, data, and choice that are expected to follow. As there is an increasing body of empirical and theoretical evidence suggesting that this disposition is unlikely, it is likewise unlikely that the perceived benefits of conventional, economic, market-contingent reforms will be fully realized. Given these findings, the proper regulation of the industry is better served by a mandatory framework designed to operate independently of the market mechanism. A unitary framework at the global level is ideal, but the effective regulation of the industry, independently of the market mechanism, begins with reform within the United States.
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