The Regulatory Divide:
Unintended Consequences of Global Financial Risk Measures for Emerging and Developing Economies

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Introduction.

This year's gatherings of the major economies, whether the G-20 in London in April or the G-8 in Lecce, Italy, in June, emphasized the effort to address global poverty and development needs and placed them directly in the context of responding to the international financial crisis. Thus, paired with the various recommendations for strengthening financial supervision and regulation, the G-20 communiqué affirmed a commitment to "helping emerging and developing economies to cope with the reversal in international capital flows," to the "the urgent need to increase IMF resources very substantially," and to ensure that "all Multilateral Development Banks have the capital they need."[2] Similarly, when the G-8 finance ministers subsequently met in Lecce, they underscored the G-20 commitments made in London and stated that they were "prepared to consider additional financing needs."[3] Nevertheless, despite this emphasis on poverty and development in the current economic crisis, the overall risk-mitigation measures

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[2] *G-20 Comuniqué Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 14 March 2009,* at 1, http://www.g20.org/Documents/2009_communique_horsham_uk.pdf. See also the section of the G-2 *The Global Plan for Recovery and Reform* (2 April 2009) on "Ensuring a fair and sustainable recovery for all" http://www.g20.org/Documents/final-communique.pdf. On pressing the need for the G-20 to take such steps, see the Brookings Global Economy and Development, *The G-20 London Summit 2009 Recommendations for Global Policy Coordination* (March 26, 2009) http://www.brookings.edu/~/media/Files/rc/reports/2009/0326_g20_summit/0326_g20_summit.pdf.
[3] *Statement of G8 Finance Ministers (Lecce, Italy 13 June 2009)* http://www.g8.utoronto.ca/finance/fm090613.htm.

proposed by international organizations and the advanced economies structurally – if not intentionally – will disadvantage emerging and developing economies.

By this, I do not mean that efforts at international cooperation may be limited in membership or when the U.S. Treasury Department in the administration's "white paper," *Financial Regulatory Reform – A New Foundation,* calls for the IMF "to expand the use of assessments and peer reviews," that such peers may also be limited in number.[4] Rather, my argument is that various risk-management proposals by the international organizations, including the International Organization of Securities Commissions ("IOSCO"), as well as by various advanced economies, as important as those risk management proposals may be, are likely to have an indirect deleterious impact on emerging and developing economies. The enhanced risk management measures – whether by the mandate of legislation or regulation, by the approaches of regulators or self-regulatory organizations, or as adopted by advanced-country financial institutions in their own risk-management policies – will place increasing emphasis on formal valuation, liquidity, and credit assessments. That in turn will require a strong valuation, liquidity, and credit infrastructure for issuers and borrowers, and it is exactly such an infrastructure that is weakest in emerging and developing economies. As a result, despite the public commitments to government aid, advanced-economy financial institutions will be discouraged from investing in or making loans to emerging-market and developing-country entities, whether public or private.[5]

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[4] Department of the Treasury, *Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation* 86 (June 17, 2009; hereafter the "White Paper") http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[5] At present, some emerging markets' public debt is doing extremely well, reportedly based on implied guarantees from the IMF. See *Financial Times* report on July 27, 2009, "Emerging nations rush to issue debt" http://www.ft.com/cms/s/0/f326fbe8-7a10-11de-b86f-00144feabdc0.html?nclick_check=1.

Despite the renewed "decoupling" debate suggesting that emerging markets may get along just fine without the advanced economies doing well, and should experience independent growth based in part on inter-emerging markets trade,[6] there are likely to be few winners in that scenario – mostly China and India, and predictions of broader Asian growth with the July announcement of gross domestic product increase in Singapore have been explicitly linked to global stimulus. Certainly for the developing economies, the situation is dire. The World Bank recently issued a press release entitled, "Global Economic Turmoil Having Dramatic Effects on Capital Flows to Developing Countries," that examined each geographical region and referred to their loss of export demand and decreased capital inflows.[7] In March, the IMF issued its report, "The Implications of the Global Financial Crisis for Low-Income Countries," which described how "[c]ommodity exporters, particularly in Latin America, Africa, and the Middle East, face a sharp decline in commodity prices, putting pressure on external accounts and government finances."[8] Indeed, "[e]xpectations of resilience in these economies had underpinned commodity prices for much of 2008, but hopes for 'decoupling' have since evaporated."[9] As a result, investors have "sought to reduce their holdings in commodity assets," which in turn reduces "credit for leveraged commodity market exposure (e.g. by hedge funds)."[10] The report then goes on to detail the risks to banks and sovereign debt markets in low-income

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[6] See, e.g., M. Ayhan Kose & Eswar Prasad, "The Decoupling Debate is Back!" *Foreign Policy* (June 2009) http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.
[7] World Bank, "Global Economic Turmoil Having Dramatic Effects on Capital Flows to Developing Countries" (June 22, 2009). http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:22216950~pagePK:64257043~piPK:437376~theSitePK:4607,00.html. See also *New York Times* article, "Just When Africa's Luck was Changing, Aug. 1, 2009), http://www.nytimes.com/2009/08/02/business/02africa.html.
[8] IMF, "The Implications of the Global Financial Crisis for Low-Income Countries (March 2009) at 3 http://www.imf.org/external/pubs/ft/books/2009/globalfin/globalfin.pdf (hereafter "IMF Report").
[9] *Id.*
[10] *Id.*

countries as well as heightened currency depreciation risks. In essence, the picture is already troubling.

Perhaps more significant is the IOSCO report released in June on the "Impact On and Responses of Emerging Markets to the Financial Crisis." It draws significantly from responses by emerging-market regulators to a questionnaire and attempts to summarize their responses to the global financial crisis.[11] There is little sign of decoupling in the report. Indeed, it asserts that "as the crisis deepened, emerging markets too were affected by the impact of worldwide de-leveraging and heightened risk aversion triggered by the global liquidity crisis and were subjected to extreme price volatility."[12] In fact, it states that the sources of "market instability included the repatriation of capital by foreign investors, withdrawal of international lines of credit and exchange rate volatility."[13] Directly in response to assertions of decoupling, it found that "[e]merging markets as a whole have become much more integrated with the global financial system, and increasingly exposed to systemic risk and subject to extreme price volatility and shock transmission as a result of global deleveraging and heightened risk aversion."[14]

There is little question that most emerging and developing economies have been hit hard by the global crisis and much of the impact has not fully played itself out. However, many of the risk-management measures, most not yet in place, designed to address the ills of the advanced-economy financial markets and systemically important institutions will further, if indirectly, harm emerging and developing economies because they depend on increased valuation, liquidity, and risk assurances that assume an

[11] IOSCO Consultation Report, "Impact On and Responses of Emerging Markets to the Financial Crisis" (June 2009) http://www.iosco.org/library/pubdocs/pdf/IOSCOPD294.pdf.
[12] *Id.* at 6.
[13] *Id.* at 10.
[14] *Id.* at 39.

infrastructure that may be weak at best. In short, the responses to the systemic risk of hedge funds, the failure of credit rating agencies, and the contagion created by credit default swaps will discourage loans to as well as investments in less developed economies.

1. Addressing Systemic Risk

The post-mortem of all that went wrong in the financial crisis has created a veritable virology of contributing factors to the contagion. And the hunt for viruses has found them in loan origination practices, overly complex securitization, and credit rating failures to central bank policy failures, misaligned incentives, and inadequate risk management at every level.[15] That list is, of course, just the beginning. Still, it is clear that at the epicenter of the advanced-economy concerns – despite the serial itemization of issues to address – is systemic risk, in essence, identifying the institutions whose failure would have material knock-on effects for the entire economy, such as the failure of Lehman Brothers. Indeed, the G-20 Communiqué spoke of making sure that "all systemically important financial institutions, markets and instruments are subject to an appropriate degree of regulation and oversight . . ."[16] And the Lecce Framework listed as a priority the "regulation of systemically important institutions."[17]

If this spring's *Turner Review* issued by the U.K. Financial Services Authority ("FSA") asserted that "[r]egulatory and supervisory coverage should follow the principle

[15] Mark Zandi does a good job of generating just such a virology in his *Financial Shock: A 360° Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis* (2008).
[16] *G-20 Communiqué Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 14 March 2009,* at 2. http://www.minfin.ru/common/img/uploaded/library/2009/07/G8_Finance_eng_(4).pdf.
[17] *Lecce Framework.*

of economic substance not legal form,"[18] the U.S. administration, faced by the so-called "microregulation" of the financial services from the series of different bank regulators to the state regulation of insurance companies, focused on identifying the institutions that truly represent systemic risk. The U.S. Treasury stated: "We propose a new, more robust supervisory regime for any firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed. Such firms, which we identify as Tier 1 Financial Holding Companies (Tier 1 FHCs), should be subject to robust consolidated supervision and regulation, regardless of whether they are currently supervised as [Bank Holding Companies]."[19] Those firms "should be subject to heightened supervision and regulation because of the greater risks their potential failure would pose to the financial system."[20] The U.S. Treasury recognized that this involved a balancing act: "At the same time, given the important role of Tier 1 FHCs in the financial system and the economy, setting their prudential standards too high could constrain long-term financial and economic growth. Therefore, the Federal Reserve, in consultation with the Council [that is, the proposed Financial Services Oversight Council], should set prudential standards for Tier 1 FHCs to maximize financial stability at the lowest cost to long-term financial and economic growth."[21] Nevertheless, the broad strokes were clear: increased regulatory focus on Tier 1 FHC capital requirements and the composition of their capital, prompt corrective action to declines in their capital levels, rigorous liquidity risk management, and additional disclosure requirements.

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[18] *The Turner Review: A regulatory response to the global banking crisis*, at 7 (March 2009) .
[19] *Financial Regulatory Reform*, at 22 www.fsa.gov.uk/pubs/other/turner_review.pdf. .
[20] *Id* at 24.
[21] *Id.*

Significantly, according to the white paper, the Tier 1 firms would need to place particular focus on their overall risk management: "These firms should be able to identify firm-wide risk concentrations (credit, business, lines, liquidity, and other) and establish appropriate limits and controls around these concentrations. In order to credibly measure and monitor risk concentrations, Tier 1 FHCs must be able to identify aggregate exposures quickly on a firm-wide basis."[22] In looking at firms on an aggregate basis, the white paper is quite clear: "Consolidated supervision of a Tier 1 FHC should extend to the parent company and to all of its subsidiaries – regulated and unregulated, U.S. and foreign."[23] Thus, the subsidiaries in emerging and low-income countries are unmistakably part of the overall risk management of the firm. From the perspective of the firm's overall risk exposure, the risks in these countries may not be seen as significant. The IMF in its study of low-income countries asserted: "The risk of sudden liquidity withdrawal is also generally attenuated by the low reliance on these markets by parent banks, as from a global point of view the funds involved are small."[24] There may be some validity to this statement, but the Latin American debt crisis of the 1980s was hardly a side-show for the banks involved. As Ngaire Woods puts it, "Several large international commercial banks were heavily overexposed in Latin America. Creditor governments needed to ensure that their own large, overexposed banks did not go bust and bring down the international financial system."[25]

I would like to emphasize less the potential for concentration at the regional, country or even company level in the emerging and developing economies and more to

[22] *Id.* at 25.
[23] *Id.* at 10 – 11.
[24] IMF Report at 11, note 9.
[25] Ngaire Woods, *The Globalizers: The IMF, the World Bank and Their Borrowers* at 47 (2006).

the general impact of an enhanced risk management culture that should appropriately flow through the entire system. Back in 2005, the National Association of Securities Dealers ("NASD") released an important Notice to Members recommending as a best practice that U.S. broker-dealers create formal procedures to review new products.[26] The NASD has stated that it was "[c]oncerned about the number of increasingly complex products that are being introduced to market" and that "[s]ome of these products have unique features that may not be well understood by investors or registered persons."[27] Apparently, the NASD effort – and similar efforts by some banking regulators[28] – may not have been well heeded by some firms. But the risk imperatives of the current crisis are too overwhelming to be ignored. Firms under scrutiny due to their systemic importance will be required to address not only risk concentrations but also their general risk management. And they will be expected to formalize enhanced procedures, committee structures, risk monitoring, and the like. The heightened risk consciousness and enhanced formalized processes can be expected to flow through the financial services and not merely be restricted to firms that pose systemic risk. One can expect increasingly formalized processes that will in turn look to formal assurances that can be provided by counterparties, investment targets, and borrowers, only starting with audited financials meeting international standards. Significantly, it is just those sources of comfort by entities from emerging and developing economies that may not meet the enhanced due diligence thresholds that are likely to emerge.

[26] NASD Notice to Members 05-26 (New Products, April 2005) http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p013755.pdf.
[27] *Id.* at 1.
[28] See, e.g., the Interagency "Credit Risk Management Guidance for Home Equity Lending" released in May 16, 2005, http://www.occ.treas.gov/ftp/bulletin/2005-22a.pdf.

2. Addressing Hedge Funds.

Hedge funds have come to be seen as mysterious powerhouses of market volatility, powerful, overleveraged black boxes that can move markets and bring down companies. If Tom Wolfe were to rewrite *Bonfire of the Vanities* today, his "master of the universe" would undoubtedly be one of the hedge fund managers which have been driving up New York real estate prices over the last decade. It is presumably with the major market impact of hedge funds in mind that the SEC is advocating adding restrictions to short-selling, such as a return to the uptick rule. And it is not by chance that in its reporting of this development, the *New York Times* described the position of the opponents of these changes: "Hedge funds and big pension funds argue that short-selling is vital to modern markets. Such trading not only enables investors to hedge their risks but also to ferret out weak companies or, as in the case of Enron, outright frauds."[29] Nevertheless, there was little doubt that the potential systemic threat posed by large, unregistered, highly leveraged, and actively trading investment vehicles – which had been presaged by the global scare with the failure of Long-Term Global Management in the late 1990s – meant that hedge funds would become a significant element of the international regulatory fix. French Finance Minister Christine Lagarde particularly pressed this issue among the French and German demands prior to the G-20 meeting. Indeed, the G-20 affirmed the need "to extend regulation and oversight to all systemically important financial

[29] "S.E.C. May Reinstate Rules for Short-Selling Stocks," *New York Times* at B1 (July 3, 2009) http://www.nytimes.com/2009/07/03/business/03shorts.html.

institutions, instruments and markets. This will include, for the first time, systemically important hedge funds."[30]

Although the systemic risk posed by hedge funds was the main issue articulated in the G-20 context, it is only one of a series of regulatory concerns about such funds. There are also concerns about investor protection, market manipulation, the impact on the business of the portfolio companies, and – as exemplified by the suggested anti-money-laundering due diligence procedures published by the Anti-Money Laundering and Financial Crimes Committee of the Securities Industry and Financial Markets Association ("SIFMA") [31] – even money laundering. And going through the list of potential issues, other investment pools may present one or more of them, including private equity funds, commodity pools, pension funds, sovereign wealth funds, and large private investment companies. The IOSCO Technical Committee's Consultation Report on Hedge Fund Oversight decided to limit itself exclusively to hedge funds: "Given the G-20 particular interest in hedge funds, the Task Force decided to focus its work on hedge funds, rather than deal with other potentially 'unregulated' entities such as private equities funds (which have very recently been reviewed by IOSCO) or Special Investment Vehicles (which could as easily be described as 'products' rather than 'entities')."[32] Nevertheless, the Technical Committee had to admit on the very next page of the report that "there is no consistent or agreed definition of the term hedge fund" and that it had "to look at the kinds of characteristics of and strategies employed by

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[30] G-20, The Global Plan for Recover and Reform (2 April 2009).
[31] "SIFMA's Anti-Money Laundering and Financial Crimes Committee Anti-Money Laundering Suggested Due Diligence Practices for Hedge Funds" http://www.frontlinecompliance.com/compliance_consultant_resources/4-09SIFMA%20aml%20hf.pdf.
[32] IOSCO Consultation Report, "Hedge Fund Oversight" at 5 (March 2009) http://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf.

institutions that would consider themselves to be hedge funds."[33] At that point it turned to the lack of leverage restrictions, the presence of significant performance fees, the periodic redemption of fund shares, the significant interest by the manager, the use of derivatives, and the presence of more diverse risk and complex products – essentially focusing mostly on a list of concerns about hedge funds to reverse-engineer a definition. The European Community in its proposed hedge fund directive went to the other extreme, defining the subject of the directive, "alternative investment funds," as any collective investment scheme (*i.e.*, managed investment pool) that is not registered under the UCITS directive (the mutual funds specifically organized under the European directive that allows "passporting" across borders to other member states in the community). Thus, even an investment trust organized under the U.K.'s pre-UCITS mutual fund regime, that is to say organized and fully registered under U.K. law, would come under this definition of a hedge fund.[34]

The proposed EU directive is not only broad in compass but it is also broad in the requirements it creates for hedge funds and other alternative investment funds as well as their managers. Indeed, the *Financial Times* has been busy following the heated responses to the proposed directive with a long list of articles with titles like "Hedge Fund Directive under Fire" (April 26, 2009), "Hedge Funds May Quit UK over draft EU Laws" (June 4, 2009), "Hedge Funds Attack Proposed EU Regulations" (June 17, 2009), "City Targets US Help in EU Hedge Fund Fight" (July 1, 2009), and "Private Equity attacks Brussels" (June 27/28, 2009). On July 2, the FT announced: "Sweden defends

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[33] *Id.* at 6.
[34] Commission of the European Communities, *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers* (30/4/2009) at 20 http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf.

private equity," reporting that "Sweden marked the first day of its six-month European Union presidency yesterday by coming to the defence of hedge funds and private equity, promising to press for improvements in EU proposals for tougher regulation of both groups" and quoting at length remarks by Matts Odell, Sweden's minister for financial markets.

The list of requirements of the proposed EU directive is unquestionably long, including enhanced risk management and due diligence by the fund; the designation of a valuator determining portfolio security value and that the valuator be independent of the fund management; the designation of a depositary; additional disclosure to investors; additional disclosure to regulators; enhanced liquidity management; established conflict-of-interest management; capital requirements for the manager; risk management for ensuring deliverability of short-sold securities; and leverage limitations that would be set by the common body of European member state securities regulators, the Committee of European Securities Regulators ("CESR"). It is not clear what the final directive will look like after the dust settles. Nevertheless, it is worth pointing to some of the key elements impacting the fund's portfolio investments, including a documented and regularly updated due diligence process for a fund's manager when investing on behalf of the fund that would "ensure that risks associated with each investment and overall effect can be accurately identified" and the appointment of an independent valuator for determining the value of the underlying assets. These, in turn, could disadvantage emerging and developing country issuers. Similarly, a fund devoted to emerging and developing economy investments may face additional challenges in complying with the liquidity-risk mandates of the proposed directive.

Similarly, the IOSCO Consultation Report, in addition to its focus on enhanced risk management, recommended that the monitoring and supervision of hedge funds by regulatory agencies include "robust verification of fund valuations." As I have been suggesting, the expectation of heightened due diligence on portfolio companies and verification of fund valuation will call for additional formal processes that will disadvantage emerging and developing economies.

The IOSCO release also reported that the industry itself in the proposed codes issued by the Hedge Fund Working Group and the Managed Funds Association similarly identified not only the need to "emphasize sound risk management practices" but also "asset valuation" that, in part, reflected "flaws in some models of valuation for illiquid assets."[35] The obvious need for an enhanced risk management culture is naturally being addressed by industry groups, but, as mentioned above, the procedures that will be adopted will likely create additional challenges for investments in emerging and developing economies, and the valuation issues for illiquid assets have always been more significant in such countries. For example, the securities markets – as prospectuses for mutual funds investing in emerging and developing economies typically warn – are less liquid. Indeed, those prospectuses will provide not sentences but rather paragraphs of risk warnings about currency risk, political risk, inflation risk, and nationalization risk, as well as issues with shareholder rights, weaker regulatory environment, and inconsistent accounting standards. All of these risks have long been understood and represents a natural element of the evaluation of potential borrowers and investment targets. The question is whether the additional risk, valuation, and liquidity steps taken by hedge

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[35] IOSCO Hedge Funds Oversight Consultation Report, at 27.

funds, either voluntarily or by new regulatory mandate, will further impact emerging and developing market borrowers and issuers.

On July 16, the U.S administration issued proposed legislation under the title "Registration of Advisors to Private Funds."[36] The proposal would create disclosure requirements for advisors of private funds, which is defined broadly as funds that are exempt from the Investment Company Act by provisions related to qualified investors and the limit to 100 or fewer persons, and would include both U.S.-domiciled funds and foreign-organized funds that are 10% owned by U.S. persons. The disclosure requirement includes, as a minimum, the "amount of assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, [and] trading and investment positions." It then provides for "such other information as the Commission, in consultation with the Board of Governors of the Federal Reserve System, determines necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk." The administration is driven by the potential that a hedge fund may pose a systemic risk, but it also clearly articulates a concern for the protection of investors. Thus, although the proposed legislation does not explicitly identify the fund's risk management in its portfolio selection, that could easily be added information or become explicitly part of the regulatory review process or the standard internal procedures of investment advisors. Certainly, the overall risk management of advisors regarding these funds is implicated by the administration's proposal – whether the risk management of portfolio selection is central or penumbral. Of course, we do not know how the administration's proposal will blend with the

[36] Title IV – Registration of Advisors to Private Funds. http://www.treas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf .

Congressional efforts to register funds under the earlier proposed Hedge Fund Transparency Act of 2009 initiated by Senators Charles Grassley and Carl Levin.[37] But the legislation, if not explicitly as extensive as the EU proposal, will likely impact portfolio management risk programs and consequently investments in emerging and developing economies.

3. Credit Rating Agencies.

The credit ratings used in structured financial products have been so entrenched in the narrative of what went wrong in the global financial crisis that they are an important part of the international regulatory fix. And as much as regulators emphasize the difference between credit rating and liquidity – IOSCO stating that the "subprime turmoil has highlighted another common misperception that credit risk is the same as liquidity risk"[38] – there is also a recognition that credit ratings will play into valuation and liquidity analysis. The same IOSCO report states:

> A credit rating, then, is occasionally viewed not only as the CRA's [i.e., a credit rating agency] opinion of the loss characteristics of the security, but also as a seal of approval. This perception is not entirely without merit given that a CRA rating of a structured financial product is qualitatively different from a corporate bond rating on an issuer's past financial statements because, in a structured financial transaction, the CRA provides the investment bank with input into how a given rating can be achieved (i.e., through credit enhancements).[39]

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[37] On the Congressional Proposal, see Anita K. Krug, "The Hedge Fund Transparency Act of 2009" posted by the Berkeley Center for Law, Business and the Economy, http://www.law.berkeley.edu/files/Hedge_Fund_Transparency_Act_Comments_A.Krug.pdfhttp://www.law.berkeley.edu/files/Hedge_Fund_Transparency_Act_Comments_A.Krug.pdf .

[38] IOSCO Final Report on the Role of Credit Rating Agencies in Structured Finance Markets (May 2008) (hereafter "IOSCO CRA Report") at 10 http://www.cmvm.pt/NR/rdonlyres/85312A11-A927-4F63-810A-082C1A2CF5F8/9759/RelIOSCOsobrePapelCRAMercProdEstrut.pdf.

[39] *Id.* at 8.

In addition, credit ratings have been built by legislators and regulators into financial services regulatory regime. It was, for example, exactly because credit rating agencies can be designated "Nationally Recognized Statistical Rating Organizations" or NRSROs, and their ratings are used for regulatory purposes (such as the net capital requirements of registered broker-dealers provided by Rule 15c3-1 under the Exchange Act and for the portfolio securities of U.S. money market funds provided by Rule 2a-7 under the Investment Company Act) that particularly compels SEC action on NRSROs[40] - despite the fact that it cannot regulate the substance or methodologies of credit ratings under the statute first giving it authority over credit rating agencies, the Credit Rating Reform Act of 2006.[41]

IOSCO in its report on credit rating agencies in structured finance markets basically added to its Code of Conduct Fundamentals for Credit Rating Agencies, which it issued at the end of 2004. It believes that the code "should govern the activities of CRAs to help them guard against conflicts of interest, ensure that their rating methodologies are used consistently by their employees, provide investors with sufficient information that they can judge the quality of a CRA's ratings, and generally help ensure the integrity of the rating process."[42] Nevertheless, the Code of Conduct Fundamentals needed to be enhanced to address the additional risks that came to light in the structured

[40] SEC Re-proposed Rules for Nationally Recognized Statistical Rating Organizations (Release No. 34-59343; File No. S7-04-09 http://www.sec.gov/rules/proposed/2009/34-59343.pdf. John Patrick Hunt has underscored Frank Portnoy's point in *The Siskel & Ebert of Financial Markets?: Two Thumbs Down for the Rating Agencies*, 77 Wash. U.L.Q. 619 (1999) and argued recently that the SEC should consider eliminating the regulatory uses of credit ratings. John Patrick Hunt, "Securities and Exchange Commission Re-Proposed Rules for Nationally Recognized Statistical Rating Organizations" (Berkeley Center for Law, Business and the Economy) at 5-6 http://www.law.berkeley.edu/files/SEC_Re-Proposed_Rating_Agency_Rules_03.026.09.pdf.

[41] 'Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings." Section (c)((2) Credit Rating Agency Reform Act of 2006.

[42] IOSCO CRA Report at 1.

finance markets. For example, the code modifications included a requirement that "CRAs should adopt reasonable measures so that the information it uses is of sufficient quality to support a credible rating. If the rating involves a type of financial product with limited historical data upon which to base a rating, the CRA should make clear, in a prominent place, the limitations of the rating."[43] There are numerous calls for testing and review functions. And, of course, the CRAs "should need to ensure that the "employees that make up their rating committees (where used) have appropriate knowledge and experience in developing a rating opinion for the relevant type of credit."[44]

The IOSCO proposals were, of course, driven by the failures in the structured finance context, but many of the added provisions have wider remit. The IOSCO Technical Committee recognized that some of its recommendations may not make sense for every credit rating agency, so that in recommending a review function of the rating methodologies, it states: "Where feasible and appropriate for the size and scope of its credit rating services, this function should be independent of the business lines that are principally responsible for rating various classes of issuers and obligations."[45] Nevertheless, despite the modification suggested by "[w]here feasible and appropriate," the overall thrust of the report clearly envisions increased resources being brought to bear. To that point it states quite directly: "CRAs should ensure that adequate resources are allocated to monitoring and updating its ratings."[46] The Technical Committee's expectations and recommendations are certainly an appropriate response to the credit rating failures that were so central to the global financial crisis. Nevertheless, if one

[43] *Id* at 14.
[44] *Id*. at 15.
[45] *Id.* at 14.
[46] *Id.* at 15.

looks at Moody's Website – with its marketing language that the firm's ratings cover more than 100 sovereign nations, 12,000 corporate issuers, 29,000 public finance issuers, and 96,000 structure finance obligations – one notices that the "Global Locator" of its offices shows only one dot for Africa – in South Africa (probably because the Cairo office is a joint venture, its presence is not represented on the map). One is prompted to ask how, for example, does Moody's cover Francophone Africa? How much local knowledge and expertise does the Johannesburg office have about companies in Senegal?

The EU's proposed directive is meant to address only the regulatory uses of credit ratings, the European equivalent of the SEC's NSRSOs, explaining that "[t]he proposed regulation is proportionate, as required by Article 5(3) of the EC Treaty. It targets not all credit rating agencies but only those whose ratings are used for regulatory purposes by financial institutions, i.e., those with a potentially high impact on the financial system."[47] Oddly, the proposed regulation begins by describing its scope as applying "to credit ratings that are intended for use for regulatory purposes *or otherwise*" by credit institutions, securities firms, UCITS mutual funds, and the like.[48] Even the European Central Bank in its comments on the proposed regulation was perplexed by this drafting inconsistency.[49] Indeed, when the proposal was formally adopted without change in April, the press release makes no mention of the regulatory use. Instead, the release unambiguously states: "As a rule all credit rating agencies that would like their credit

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[47] Commission of the European Communities, Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies (12 November 2008) at 6 (hereafter "EU Credit Rating Agency Proposal") http://ec.europa.eu/internal_market/securities/docs/agencies/proposal_en.pdf.
[48] *Id.* at 18 [emphasis added].
[49] *Opinion of the European Central Bank of 21 April 2009 on a proposal for regulation of the European Parliament and of the Council on credit rating agencies* at 2 http://www.ecb.eu/ecb/legal/pdf/en_con_2009_38.pdf.

ratings to be used in the EU will need to apply for registration."[50] Like the IOSCO Report, the EU release talks to the need for a credit rating agency "to use rating methodologies that are rigorous, systematic, and continuous and result in ratings that may be subject to validation based on historical experience. Credit rating agencies should ensure that methodologies, models and key rating assumptions used for determining credit ratings are properly maintained, up-to-date and subject to comprehensive review on a periodic basis."[51] Placing the burden on the credit rating agency to validate the information provided to it for a rating, the release also states that "[i]n order to ensure the quality of ratings, a credit rating agency should take measures to ensure that the information it use[s] in assigning a rating is reliable."[52] And among the suggestions provided, in addition to the use of third-party services such as audited financials, it mentions "random sampling examination by the credit rating agency of the information received."[53] In short, the process and infrastructure expectations are set high and create a threshold that is particularly difficult in the context of emerging and developing markets.

In her book on structured finance and collateralized debt obligations, Janet Tavakoli devotes a few pages to "Emerging Markets Caveats" in which she asks: "Does the BBB rating for an emerging markets CDO tranche reflect the same cash flow certainty as the BBB rating of an investment-grade rated corporate deal?"[54] Her answer to that along with a series of other emerging-markets questions is decidedly "no." She states: "The lack of experience and expertise with economic or political instability in a

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[50] Press release April 23, 2009. http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/629&format=HTML&aged=0&language=EN&guiLanguage=en.
[51] EU Credit Rating Agency Proposal at 13.
[52] *Id.*
[53] *Id.* at 14.
[54] Janet M. Tavakoli, *Structured Finance and Collateralized Debt Obligations: New Developments in Cash and Synthetic Securitization* (2d ed. 2008) at 379.

given country is a serious disadvantage to rating agencies. While Fitch feels they are taking this into account when assigning a rating for future flows deals . . . , the simple truth is they are guessing how severe sovereign reaction will be in times of economic or political crisis."[55] Then in a flippant tone she writes: "I don't mean to pick on the Republic of Turkey, but – hold on. Yes, I do, because it is a good example of how easy it is to lull ourselves into a belief that appearance is reality."[56] Tavakoli's tone aside, one can hardly dismiss her concerns about the credit rating agencies' ability to assess emerging and developing market credit, which would suggest more rather than less diligence. But the question remains what the impact will be on credit coming from those nations.

Conclusion.

Dambisa Moyo is currently on the interview and lecture circuit talking about her book, *Dead Aid: Why Aid is Not Working and How There is a Better Way for Africa.* Describing a dysfunctionality resulting from government aid, Moyo talks of Africans going to the private market for funding and energetically points out that nineteen African nations have credit ratings, which for her is just the start. She acknowledges that perhaps her prescription for Africa may have to wait until the current financial crisis ends, but that remains her answer. My effort here is to suggest that the reforms being instituted by legislators, regulators, self-regulatory organizations, and regulated financial services companies – reforms responding to what went wrong – will only make it more difficult

[55] *Id.*
[56] *Id.*

for public and private issuers and borrowers in the emerging and developing sphere. The unintended consequence of the regulatory reform is likely to mean that aid and public resources will become more rather than less important as sources of funding.

On August 4, the *Financial Times* announced on the first page of its *Companies and Markets* section: "Emerging markets surge as investors eye global recovery."[57] Basically, the paper reported a regain of much of the ground lost in the stock markets of the emerging economies since the collapse of Lehman Brothers, citing commentators on the impact of "decoupling" as well as early global indications of growth. But despite the fact that there was a rise in the Jakarta Composite and the Peru Lima General, by far the greatest winner was the Shanghai SE Composite. Putting aside the paper's reporting that "some worried that it might have gone too far, too fast," that this resurgence itself may be have boom-like characteristics,[58] it may still be too early to see the impact of the international regulatory changes I have discussed.

[57] "Emerging markets surge as investors eye global recovery" *Financial Times* Aug. 4, 2009 http://www.ft.com/cms/s/0/fa0af7a4-808f-11de-bf04-00144feabdc0.html.

[58] Indeed, on August 20, 2009, the *New York Times* reported "Key Index in China Falls on Fear of a Bubble," http://www.nytimes.com/2009/08/20/business/20markets.html.