

Recasting Credit Rating Agencies' Responsibility: Suggestions for Reform

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DECLARATION

I declare that the work presented in this thesis is the result of my own research and that it has not been submitted anywhere for an award. Where other sources of information have been used, they have been acknowledged.

Andrea Miglionico

London, 2 December 2014

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Abstract

The credit rating agencies (CRAs) have become major players in the financial markets yet their reputations have been tarnished by certain assessments issued during the 2007-2009 financial crisis. There is therefore a clear need to regulate the practice of the highly influential, though at times inaccurate, ratings of these agencies. The overriding proposition is that CRAs should be liable for the issuance of inaccurate ratings. The analysis maps the contours of the legal aspects of the credit ratings market before addressing the major questions regarding a CRA's *modus operandi*. It is argued that CRAs are capable of bringing about potential distortions in the financial sector, thereby resulting in a reduction in market confidence which, in turn, influences negotiations and expectations. In this regard, a civil liability regime for CRAs could constitute a system of investor protection over and above traditional regulation.

The purpose of this thesis is to demonstrate that the present system for regulating CRAs in the US, the UK and the EU is defective in terms of information asymmetries, an absence of transparency, conflicts of interest and limited competition. The thesis considers whether an effective liability regime through the 'estoppel rule' could be a valid option in the case of CRAs. In this light, the thesis attempts to demonstrate that CRAs should be regulated having due regard to their potential systemic threat. Further, the thesis suggests that CRAs should be subject to professional standards similar to those applicable to other information intermediaries such as auditors and financial analysts. The idea is that CRAs should be made responsible for their investment certification because of their fundamental role in the evaluation of credit risk and their influence on confidence and decisions in the market. The research brings forth a range of recommendations aimed at reforming the current regulatory framework.

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Keywords: Credit rating agencies, securities regulation, civil liability regime, estoppel, conflicts of interest, over-reliance, reputational capital.

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Abbreviations

ABS	Asset-backed securities
AFME	Association for Financial Markets in Europe
AFSL	Australian Financial Services License
AIFM	Alternative Investment Fund Manager
ASIC	Australian Securities and Investments Commission
BBC	British Broadcasting Corporation
BCBS	Basel Committee on Banking Supervision
BCOB	Basel Committee Oversight Body
BIS	Bank for International Settlements
BoE	Bank of England
CAD	Capital Adequacy Directive
CCC	Central Counterparty Clearing
CCRs	Central Credit Registers
CDOs	Collateralized Debt Obligations
CDS	Credit Default Swap
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CFSDs	Central Financial Statements Databases
CGFS	Committee on the Global Financial System
CPDO	Constant Proportion Debt Obligation
CRAs	Credit Rating Agencies
CRAAC	Credit Rating Agency Assessment Centre
CRD	Capital Requirements Directive
DoJ	US Department of Justice
EBA	European Banking Authority
EC	European Commission
ECAIs	External Credit Assessment Institutions
ECB	European Central Bank
ECGI	European Corporate Governance Institute
ECOFIN	Economic and Financial Affairs Council
ECON	Committee on Economic and Monetary Affairs
EFSF	European Financial Stability Facility

EFSM	European Financial Stabilisation Mechanism
EIOPA	European Insurance and Occupational Pensions Authority
ESAs	European Supervisory Authorities
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESME	European Securities Markets Expert Group
ESRB	European Systemic Risk Board
EU	European Union
FD	Fair Disclosure
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
Fed	Federal Reserve System
FIs	Financial Institutions
FSA	Financial Services Authority
FCA	Financial Conduct Authority
FSB	Financial Stability Board
FSC	Financial Stability Committee
FSCS	Financial Services Compensation Scheme
FSF	Financial Stability Forum
G-7	Group of Seven
G-20	Group of Twenty
G-SIFI	Globally Systematically Important Financial Institution
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
ICAAP	Internal Capital Adequacy Assessment Process
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRB	Internal Rating Based
LOLR	Lender of Last Resort
LTCM	Long Term Capital Management
MAD	Market Abuse Directive
MiFID	Markets in Financial Instruments Directive

MBS	Mortgage-backed security
MSRs	Mortgage Servicing Rights
NAISC	US National Association of Insurance Commissioners
NBER	National Bureau of Economic Research
NCBs	National Central Banks
NRSRO	Nationally Recognized Statistical Rating Organization
OAS	Option Adjusted Spread
OECD	Organization for Economic Cooperation and Development
OTC	Over-the-Counter
PRA	Prudential Regulation Authority
RACs	Rating agency confirmations
RMBs	Residential mortgage-backed securities
S&P's	Standard & Poor's
SEC	Securities and Exchange Commission
SIFI	Systematically Important Financial Institution
SIFMA	Securities Industry and Financial Markets Association
SIVs	Structured investment vehicles
SLS	Special Liquidity Scheme
SMEs	Small and medium-sized enterprises
SOPs	Standard Operating Procedures
SPV	Special Purpose Vehicle
SREP	Supervisory Review Process
SRR	Special Resolution Regime
TALF	Term Asset-Backed Securities Loan Facility
UCITs	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
US	United States
VaR	Value at Risk
WB	World Bank
WG	Working Group

Chapter One

Introduction

“The pronouncements of these high priests of finance...affect the costs of funds for issuers of debt...ratings can single-handedly create or render obsolete particular kinds of securities. A downgrade can even tip countries towards recession or companies towards bankruptcy”.

Richard Beales, Saskia Scholtes and Gillian Tett, FT, London 17 May 2007¹

1.1 Overview and terms of reference

Nowadays, it is commonly considered that credit rating agencies (CRAs) play a key role in the financial markets because of their general perception as an information intermediary between investors and issuers.²

CRAs are private companies which provide public opinions as to the creditworthiness of debt instruments (bonds and commercial paper) and are mainly financed by commission fees.³

Ratings are based on issuers' public information and are taken into account in determining matters such as trends and investment decisions. In fact, ratings estimate the risk in relative rank order, but they do not predict credit risks of a specific frequency of default or loss.⁴ As Reisberg observed 'ratings are forward-looking statements which represent the raters' judgement of the creditworthiness of an entity'.⁵

¹ Richard Beales, Saskia Scholtes and Gillian Tett, 'Failing grades? Why Regulators Fear Credit Rating Agencies May Be Out of Their Depth' *Financial Times* (London, 17 May 2007).

² Arturo Estrella et al., 'Credit Ratings and Complementary Sources of Credit Quality Information', BCBS Working Papers No 3, 11, where it is pointed out that 'credit rating agencies play a useful role by collecting information about a firm and sharing it with a large number of investors'.

³ As defined by Section 3(a) (60) of the US Credit Rating Agency Reform Act 2006, credit rating means 'an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments'. See also Article 3 of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (OJ 2009 L 302, p. 1): (a) 'credit rating' means an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories; (b) 'credit rating agency' means a legal person whose occupation includes the issuing of credit ratings on a professional basis.

⁴ Damien Fennel and Andrei Medvedev, 'An economic analysis of credit rating agency business models and ratings accuracy' (November 2011) Financial Services Authority, Occasional Paper Series No 41, 9-10.

⁵ Arad Reisberg, 'The future role of credit rating agencies in contemporary financial markets – A

CRAAs provide an assessment of the ability of issuers to meet their debt obligations through information monitoring services that promote liquid markets.⁶ In academic circles, CRAAs are classed as ‘certification intermediaries’⁷ or ‘reputational intermediaries’.⁸ It can be said that CRAAs are reputational intermediaries providing certification services to investors. These services regularly consist of monitoring and assessing a company’s creditworthiness.

Above all, CRAAs provide two essential services: (1) solicited ratings, where the issuer requests a rating for its securities in return for a fee; and (2) unsolicited ratings, which are based only on publicly available information and no fee is paid.

The CRAAs’ business model, whereby the rating agencies are paid by the self-same entities whose products they are rating, is often referred to as the ‘issuer-pays’ model. This system was adopted by the main CRAAs (Moody’s, Standard & Poor’s (S&P’s), Fitch IBCA, Duff and Phelps Credit Rating Co.) in the early 1970s. Consequently, the main credit-rating firms changed their business models from the ‘investor-pays’ model established by John Moody in 1909 to an ‘issuer-pays’ model.⁹ Indeed, it is instructive that the entities whose products are being rated are the very parties who are actually paying for their products to be rated.

The CRA is paid by the party wishing to be assessed but ‘its relative credibility stems from the fact that it is in effect pledging a reputational capital that it has built up over many years of performing similar services for numerous clients’¹⁰.

theoretical perspective’ in Dan Prentice and Arad Reisberg (eds.), *Corporate Finance Law in the UK and EU* (Oxford: OUP 2011) 173.

⁶ John Kiff, Allison Holland, Michael Kisser, Sylwia Nowak, Samer Saab, Liliana Schumacher, Han van der Hoorn and Ann-Margret Westin, ‘The Uses and Abuses of Sovereign Credit Ratings’ in IMF World Economic and Financial Surveys. Global Financial Stability Report. Sovereigns, Funding and Systemic Liquidity (October 2010) 88-89.

⁷ Stephen Choi, ‘Market Lessons for Gatekeepers’ (1998) 92 *Northwestern University Law Review* 3, 924. See also Jonathan Macey, ‘Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation’ (1998) 65 *University of Chicago Law Review* 4, 1500.

⁸ Reiner H. Kraakman, ‘Corporate Liability Strategies and the Costs of Legal Controls’ (1984) 93 *Yale Law Journal* 5, 895-896; see also Reiner H. Kraakman, ‘Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy’ (1986) 2 *Journal of Law, Economics, and Organization* 1, 54. From this perspective, the CRAAs are repeat intermediaries who provide certification or verification services to investors. The issuer uses the reputational intermediary to send a credible signal that its securities are of above average quality in order that it can pay a below average interest rate. See on this point John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (Oxford: OUP 2006) 288.

⁹ The main CRAAs nowadays are Moody’s Investor Service, Standard & Poor’s Ratings Services and Fitch Ratings.

¹⁰ John C. Coffee Jr., ‘Understanding Enron: “It’s About the Gatekeepers, Stupid” (2002) 57 *The Business Lawyer* 4, 1405.

The International Organization of Securities Commissions (IOSCO) defines a credit rating as ‘an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system; they are not recommendations to purchase, sell, or hold any security’.¹¹ According to this definition, credit rating opinions do not constitute recommendations for investors but simply opinions or views evaluating the likelihood of timely repayment.

Nonetheless, ratings do provide valuable information regarding decisions made by investors and regulators. However, the exercise of freedom of expression carries with it duties and responsibilities which may be subject to restrictions such as liability for false and misleading misrepresentations or gross negligence prescribed by law as necessary for the prevention of market disorder.¹² So the question is whether a ‘mere opinion’ can be considered to carry with it an exemption from any responsibilities. If this notion of CRAs as providers of ‘mere opinions’ is accepted, CRAs cannot be held liable for losses arising from detrimental reliance on their ratings.¹³

A question that needs to be addressed is whether there is any scope for considering an opinion—on which investors and consumers have placed reliance—as carrying liability. In other words, whether CRAs can be liable for investors’ losses on the basis that the investors relied on the ratings.

In 2009, the District Court of New York held that ‘ratings on notes sold privately to a select group of investors were not matters of public concern deserving of traditionally broad protection under the First Amendment of the US Constitution’.¹⁴ This ruling provided a new perspective on the accountability of CRAs because it held that ratings of securities that were distributed to a limited number of investors did not deserve the same free-speech protection as more

¹¹ IOSCO Technical Committee, ‘Code of Conduct Fundamentals for Credit Rating Agencies’ (December 2004) 3.

¹² In such case, it is necessary to draw a parallel with the law of defamation, where the right to freedom of expression has to be balanced against the right to one’s reputation and family life (privacy) as well as data protection. Defences under English law include justification (i.e. what you are saying is true) and freedom of speech may be the subject to certain privileges in the public interest. Otherwise, damages may be payable.

¹³ Gregory Husisian, ‘What Standard of Care should govern the world’s shortest editorials?: An analysis of Bond Rating Agency Liability’ (1990) 75 *Cornell Law Review* 2, 454-455. The author argues that ‘ratings are editorial opinions, published in letter form’.

¹⁴ *Abu Dhabi Commercial Bank et al. v Morgan Stanley & Co., et al.* [2009] District Court of New York, No 08-7508. This is a relevant case in which a US Court has not held that agency ratings constitute protected commercial speech under the First Amendment.

general ratings of corporate bonds that were widely disseminated.¹⁵ In their defence, CRAs frequently argue that they are not party to any contractual relationship with investors but only with issuers. As a result, the main relationship is between the CRAs and the companies that request the security rating.

A central theme of this research concerns responsibility; therefore it is necessary to take account of the CRAs' liability regime. In particular, the scholarly debate about the liability system for the governance of CRAs is considered.

In this chapter, an overview of the main questions surrounding the CRAs' activities is provided, as well as a map of the role of ratings in the financial markets. It explores the CRAs accountability by taking into account the importance of making the rating agencies liable when ratings are inaccurate or misleading.

The chapter also considers the possibility of introducing internal controllers such as compliance officers to improve disclosure and transparency in the financial markets. This reflection identifies some key aspects, notably the extent to which the ratings industry can reduce conflicts of interest and investors' over-reliance. It further addresses the need to enhance the organizational and governance rules of CRAs.

1.2 *Credit rating agencies: how they work*

Generally speaking, CRAs play the role of a driver of the securities market and are 'hardwired' into the regulatory system. In particular, CRAs provide advice for investors, who are often subject to restrictions as to their ownership of debt of a certain grade.

The 2007-2009 financial crisis has given rise to an expansion of the CRAs' power worldwide and revealed not only market and regulatory failure, but also the failure of the current laws governing credit ratings.¹⁶

¹⁵ *ibid* 33. In particular, the Court held that 'where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the protection of the First Amendment'.

¹⁶ Nicholas Dorn, 'Policy stances in financial market regulation: Market rapture, club rules or democracy?' in Kern Alexander and Niamh Moloney (eds.), *Law Reform and Financial Markets* (Cheltenham: Edward Elgar 2011) 45-46.

Risk management failed to recognize the powerful function of ratings and their potential systemic effects on financial markets as the global crisis confirmed that there was an overdependence on CRAs.¹⁷ Specifically, CRAs created a systemic risk because of the scant incentive for them to perform their screening accurately, while policymakers, institutional investors and global regulators underestimated the functions of the risks stemming from CRAs. The magnitude of the systemic risk brought about by ratings in the banking and securities system represents a threat to financial stability. This is because it results in a distortion in the structure of the securities market (i.e. falls in market value driven by downgrades, lack of transparency and the capacity to cause herding among investors).¹⁸

In essence, investors in securities misunderstood the key role played by credit ratings in the investment decisions of financial participants and the widespread use of ‘ratings triggers’ in private contracts as discussed in the next chapter.¹⁹

The power of CRAs has more to do with moral suasion tools than with governmental influence because ‘this informal power becomes formal only when politicians make it so. Regulators naturally milk the agencies when things are going well and scapegoat them when things are bad’.²⁰

The securities market has also revealed that CRAs have led to tighter oversight of gatekeepers, i.e. ‘independent professionals who pledge their reputational capital to protect the interests of dispersed investors who cannot easily take collective action’²¹ (for instance, private parties which act to facilitate access to the securities market by providing financial services to investors) while also

¹⁷ Amadou N.R. Sy, ‘The Systemic Regulation of Credit Rating Agencies and Rated Markets’ (2009) IMF Working Paper 129, 29.

¹⁸ Iain MacNeil, ‘Credit rating agencies: regulation and financial stability’ in Thomas Cottier, Rosa M. Lastra and Christian Tietje (eds), *The Rule of Law in Monetary Affairs* (Cambridge: CUP 2014) 189.

¹⁹ Rating triggers are contractual provisions that give counterparties and lenders the right to terminate the credit availability, accelerate credit obligations, or have the borrower post collateral in the event of specified rating actions, such as if the rating of the borrower’s fixed-income securities falls below a certain level. See Committee of European Securities Regulators, ‘CESR’s technical advice to the European Commission on possible measures concerning credit rating agencies’ (March 2005) 38 and 87-93.

²⁰ Christopher Caldwell, ‘An inconvenient truth: the power of moral suasion’ *Financial Times* (London, 9 December 2011).

²¹ John C. Coffee Jr., ‘Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms’ in Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda and Harald Baum (eds.), *Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan and the US* (Oxford: OUP 2005) 605-606; see also John C. Coffee Jr., ‘The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting’ (2001) Columbia Law School Working Paper No 191, 2.

revealing the limits of regulators' power. The ratings had become essential to any transaction and regulatory intervention relied on the reputational capital of CRAs. For instance, buy-side firms such as pension funds, mutual funds and insurance companies have made huge use of ratings assessments in order to ensure compliance with statutory laws.²²

In this respect, ratings had become a valuable benchmark in the banking and securities markets because of their use in bank capital regulation for macro-prudential supervision and the control of systemic risks.²³ Indeed, the Financial Services Authority (FSA) noted²⁴ that regulators placed significant reliance on external ratings as part of the calculation of capital requirements in accordance with the Capital Requirements Directive (CRD).²⁵

The ratings are involved in the regulatory standards of capital requirements (especially in the so-called pillar I 'Minimum Capital Requirements' of the Basel II Accord) and in setting capital models for credit risk.²⁶ CRAs play an important role in the capital adequacy regulation of banks and in the determination of regulatory capital through the 'standardised approach'.²⁷

The Basel III framework assessed measures to mitigate the reliance on external ratings of the Basel II regime. These measures included requirements for banks to perform their own internal assessments of externally-rated securitization

²² Securities and Exchange Commission, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets. As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002' (January 2003) 28.

²³ Kern Alexander, 'The Risk of Ratings in Bank Capital Regulation' (2014) 25 *European Business Law Review* 2, 295-296. It is observed that 'central banks used credit ratings in their open market and liquidity operations to determine the type of bonds and other debt instruments they would take as collateral and the margin or haircut applied to such collateral when purchasing bonds or lending cash to participating financial institutions' (at 298).

²⁴ Financial Services Authority, 'A Regulatory Response to the Global Banking Crisis', Discussion Paper No 09/2, March 2009, at para 1.57.

²⁵ Directive 2013/36/EU of the European Parliament and the Council of 26 June 2013 on access to the activity and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC—Capital Requirements Directive IV (OJ 2013 L 176, p. 338).

²⁶ Howell E. Jackson, 'The Role of Credit Rating Agencies in the Establishment of Capital Standards for Financial Institutions in a Global Economy' in Eilís Ferran and Charles A.E. Goodhart (eds), *Regulating Financial Services and Markets in the Twenty First Century* (Oxford: Hart Publishing 2001) 315-322. See also Rolf H. Weber and Aline Darbellay, 'The regulatory use of credit ratings in bank capital requirement regulations' (2008) 10 *Journal of Banking Regulation* 1, 4-5.

²⁷ Deniz Coskun, 'Credit-rating agencies in the Basel II framework: why the standardized approach is inadequate for regulatory capital purposes' (2010) 25 *Journal of International Banking Law and Regulation* 4, 157-158.

exposures.²⁸ It has been rightly observed that ‘it seems paradoxical that the regulators, on the one hand, criticize credit rating agencies for their role in the financial crisis and subject them to regulatory control but, on the other hand, leave them the key to the financial markets’.²⁹

Chapter two elaborates on the increasing role of CRAs in the financial markets which, can be explained by the reputational incentives and regulatory license model.³⁰ The former only works if the intermediary has gained sufficient reputational capital to be trusted by investors³¹, while the latter functions by reducing the issuer’s costs, or the costs of financial intermediaries, allowing CRAs to sell regulatory licenses to enable such persons to avoid these costs.³²

As Partnoy observed, ‘the rating agencies have evolved from information providers to purveyors of regulatory licenses’.³³ Specifically, securities regulation has increasingly relied on credit ratings and the credit rating agencies sector.

The regulators have used credit ratings in a variety of ways, for instance to assess the sovereign debt of countries and have conferred on CRAs some ‘regulatory licenses’. Such ‘licenses’ granted to companies and financial institutions the right to be in compliance with regulation.³⁴ In this regard, ‘regulatory licenses, and the behavioural overdependence on ratings that followed them, ultimately led to the creation and growth of the financial instruments at the core of the recent crisis’.³⁵

The benefits associated with these regulatory licenses stem from securities laws, self-regulatory principles and uncertain court decisions.³⁶ This scenario

²⁸ Basel Committee on Banking Supervision, ‘Basel III: A global regulatory framework for more resilient banks and banking systems’ (June 2011) 4.

²⁹ Jan Oster, ‘Who Rates the Raters? The Regulation of Credit Rating Agencies in the EU’ (2010) 17 *Maastricht Journal of European and Comparative Law* 4, 374.

³⁰ Frank Partnoy, ‘Barbarians at the gatekeepers?: a proposal for a modified strict liability regime’ (2001) 79 *Washington University Law Quarterly* 2, 494. Partnoy observes that ‘a good reputation is valuable in transacting with other parties, and reputational capital enables parties to use trust to reduce the costs of transacting’.

³¹ Douglas W. Diamond, ‘Reputation Acquisition in Debt Markets’ (1989) 97 *Journal of Political Economy* 4, 829-832.

³² John C. Coffee Jr. (note 8) 288.

³³ Frank Partnoy, ‘Rethinking regulation of credit-rating agencies: an institutional investor perspective’ (2010) 25 *Journal of International Banking Law and Regulation* 4, 188.

³⁴ Arad Reisberg (note 5) 179.

³⁵ Frank Partnoy, ‘Historical Perspectives on the Financial Crisis: Ivar Kreuger, the Credit-Rating Agencies, and Two Theories about the Function, and Dysfunction, of Markets’ (2009) 26 *Yale Journal on Regulation* 2, 442-443.

³⁶ Frank Partnoy, ‘The Siskel and Ebert of Financial Markets?’ Two Thumbs Down for the Credit Rating Agencies’ (1999) 77 *Washington University Law Quarterly* 3, 623. The author argues that ‘credit ratings are valuable not because they contain valuable information, but because they grant

allows CRAs to circumvent the rules and avoid liability for misrepresentations or misconduct and, most importantly, any monitoring of their assessments.³⁷ Ratings downgrades can trigger sales of certain financial products, thus highlighting the agencies' powerful role. Such regulatory licenses allow CRAs to engage in dubious practices including omissions and misleading opinions, as for instance in the Enron case.³⁸ In sum, investors use ratings to make decisions on the credit risk of fixed-income securities and financial regulators use credit ratings to increase the monitoring of the risk of investments held by regulated entities.

Ratings are, however, also used by regulators to determine when particular investment products can be sold to the public and as a diversification tool to manage institutional investment. This means that the market price is influenced by rating pronouncements and CRAs' opinions that can affect financial confidence. It has been argued that 'the success of debt-raising by an issuer depends on the rating of the debt, with the rating a prerequisite which determines the interest rate offered and the cost of capital'.³⁹

Notwithstanding this, as intermediaries, credit ratings should profit from protecting investors because they manage 'market information', which is generally considered to be a public good.⁴⁰ In this light, ratings can be viewed as a public good because the provision of financial information can disclose

issuers regulatory licenses; a good rating entitles the issuer (and the investor in a particular issue) to certain advantages related to regulation' (at 681). Partnoy also observes that rating agencies sell information and survive based on their ability to accumulate and retain reputational capital. But once regulation is passed that incorporates ratings, rating agencies begin to sell not only information but also the valuable property rights associated with compliance with that regulation (at 682).

³⁷ John C. Coffee Jr. (note 8) 288. Coffee points out that 'the core idea behind the regulatory license is that regulation imposes costs which a favourable rating can reduce'. He states that 'a rating enables issuers to escape costly regulatory burdens or prohibitions to which they would otherwise be subject; or portfolio managers and institutional investors gain legal protection by virtue of such a credit-rating, because it insulates them from potential claims that they breached their fiduciary duties to investors in buying or holding the security'.

³⁸ John C. Coffee Jr., 'What caused Enron? A capsule social and economic history of the 1990s' (2004) 89 *Cornell Law Review* 2, 287-297. Coffee observes that the failure of the gatekeepers to detect Enron's collapse can be explained by the 'general deterrence' and 'bubble market' hypotheses. The first focuses 'on the decline in the expected liability costs that faced auditors who were considering whether or not to acquiesce in aggressive accounting policies favoured by managers'. The second focuses on the fact that—in an atmosphere of market euphoria—'gatekeepers have less relevance and, consequently, reduced leverage with their clients'. See also Deniz Coskun, 'Credit rating agencies in a post-Enron world: Congress revisits the NRSRO concept' (2008) 9 *Journal of Banking Regulation* 4, 266-269.

³⁹ Niamh Moloney, *EC Securities Regulation* (2nd edn, Oxford: OUP 2008) 689.

⁴⁰ Stephen Choi, 'A Framework for the Regulation of Securities Market Intermediaries' (2004) 1 *Berkeley Business Law Journal* 1, 48.

information that benefits the public.⁴¹ Consequently, CRAs are trusted fiduciaries and mainstays of the financial community. As Strier noted, ‘in bond ratings, the rating agencies are the key gatekeepers, in whom the trust of the investing public is reposed; public trust in any corporate gatekeeper is founded upon faith in its corporate governance apparatus’.⁴²

In the aftermath of the 2007-2009 financial crisis, confidence in the rating agencies to ‘get it right’ was shaken by a growing amount of criticism and controversy.⁴³ At the same time, the integrity of the CRAs’ activity is threatened by the demands of winning and retaining clients in the more lucrative consultancy business.

In this respect, the *modus operandi* of CRAs raises major questions. As stated earlier, the relevance of this lies in the fact that credit ratings affect market confidence and influence investors’ decisions and their expectations. For this reason, it is assumed that CRAs represent a potential distortion—in terms of market failure⁴⁴—for the securities industry.

In this way, this thesis aims to show the importance for CRAs in maintaining investors protection. Consequently, the analysis is based on the assumption that CRAs should improve the incentives to supply complete available information and promote fair competition. In other areas, CRAs should enhance financial stability for market participants.

It is plain that if a financial market is stable, everybody benefits. However, Turner warned that ‘financial instability is driven by human myopia and imperfect

⁴¹ It is generally considered by the economic literature that ‘a public good is one where the consumption of the good by one individual in no way prevents others consuming the good or diminishes their enjoyment of it’. In other terms, a public good is one where there is no rivalry and non-exclusion in consumption. See David M. Kreps, *A Course in Microeconomic Theory* (London: Harvester Wheatsheaf 1990) 168.

⁴² Franklin Strier, ‘Rating the Raters: Conflicts of Interest in the Credit Rating Firms’ (2008) 113 *Business and Society Review* 4, 539.

⁴³ John Patrick Hunt, ‘Credit rating agencies and the “worldwide credit crisis”: the limits of reputation, the insufficiency of reform, and a proposal for improvement’ (2009) *Columbia Business Law Review* 1, 112-114. See also Efraim Benmelech and Jennifer Dlugosz, ‘The alchemy of CDO credit ratings’ (2009) 56 *Journal of Monetary Economics* 5, 630-633.

⁴⁴ Francis M. Bator, ‘The Anatomy of Market Failure’ (1958) 72 *The Quarterly Journal of Economics* 3, 351, where market failure is defined as ‘the failure of a more or less idealized system of price-market institutions to sustain “desirable” activities or to estop “undesirable” activities’.

rationality as well as by poor incentives, and because any financial system will mutate to create new risks in the face of any finite and permanent set of rules'.⁴⁵

In light of these considerations, this research intends to explore the major issues concerning the internal governance of CRAs. It analyses the development of CRAs and how their influence on the decisions and expectations of financial participants has increased in recent years. Above all, this research highlights the CRAs' role in building market confidence and investors' belief in financial products.

The next section provides an overview of the nature and extent of regulatory reliance on ratings. It places particular emphasis on the powerful role of CRAs in financial markets. This section also addresses the initial shortcomings associated with CRAs' activities.

1.3 *The problems*

This research assumes that CRAs play the role of 'financial gatekeepers' by giving an evaluation of the creditworthiness of securities products. This means that CRAs are entities established to measure the relative risk that a borrower will fail to meet its financial commitments, such as interest payments and repayment of principal on a timely basis.⁴⁶

CRAs aspire to act as 'forecasters' with regard to the debt liability of the issuer and its probability of default. However, accuracy of forecasting is the key question of credit rating.⁴⁷ However, the gatekeeper's function begs the question of what kind of liability should be attached to ratings.

It is instructive to observe that despite the criticism that has been levelled in various quarters on account of the effects of the recent downgrades, investors continue to choose the same CRA players, namely Standard & Poor's, Moody's and Fitch. This raises an important concern about the significant reliance of

⁴⁵ Adair Turner, 'Reforming finance: are we being radical enough?', 2011 Clare Distinguished Lecture in Economics and Public Policy, Clare College, Cambridge, 18 February 2011.

⁴⁶ John Kiff, Allison Holland, Michael Kissler, Sylwia Nowak, Samer Saab, Liliana Schumacher, Han van der Hoorn and Ann-Margret Westin (note 6) 88.

⁴⁷ According to Coffee, 'the accuracy of a credit rating is only demonstrated over the long-run, but the payment for it is made in the short-run. This mismatch can create agency problems, as the managers who determine the rating may expect (or intend) to be around at the end of the ratings cycle'. See John C. Coffee Jr., 'Ratings Reform: The Good, The Bad, and The Ugly' (2010) European Corporate Governance Institute, Law Working Paper No 145, 29.

investors and the weakness of ‘reputational incentive theory’.⁴⁸ Another relevant question is how to deal with the ‘issuer-pays’ business model of CRAs. This is, undoubtedly, the most critical aspect of the ratings industry because of the inherent risk of conflicts of interest.⁴⁹

CRAs’ knowledge of the consequences of inaccurate prediction might be considered to be morally equivalent to knowingly publishing a misleading assessment.⁵⁰ To eliminate or reduce this kind of risk there is a need for investors to refer to CRAs that are set up only for genuine insight or for customized analysis.

This research shows that the potential damage of publishing misleading assessments is inextricably intertwined with the problem of consumer protection and market confidence.⁵¹

The accuracy of CRAs’ forecasting creates their reputation and provides a clear pattern for understanding predictions. Issuers pay for an objective prediction while investors (or consumers) rely on an independent assessment. However, the predictions are only very rarely subjected to empirical verification, and when such verification is attempted, some of the predictions are shown to be unreliable.⁵²

It is generally asserted that the inaccuracy of rating is due to the existence of: (1) conflicts of interest; (2) the lack of proper competition; and (3) reluctance to make a disclosure, since a key feature of ratings is the provision of information.⁵³

⁴⁸ Tom Hurst, ‘The role of credit rating agencies in the current worldwide financial crisis’ (2009) 30 *Company Lawyer* 2, 64.

⁴⁹ As indicated, CRAs operate under an ‘issuer-pays’ model under which issuers request agencies to provide ratings which are a prerequisite for external debt financing.

⁵⁰ Rolf Weber and Simone Baumann, ‘Conflicts of Interest and Risk Management Practices in the CRA Industry’ in Jan Kleineman, Lars Gorton and Verständig (eds), *Perspectives on Credit Rating Agencies* (Stockholm: Författarna, Stockholm Centre for Commercial Law Jure Förlag AB 2013) 290. The authors argue that in the ratings industry ‘the issuer-pay business model is not considered to be problematic because the CRA would have much more to lose by endangering their reputation for objectivity than they would have to gain if they favor one single customer’. See also Steven L. Schwarcz, ‘Private Ordering of Public Markets: The Rating Agency Paradox’ (2002) *University of Illinois Law Review* 1, 17-18.

⁵¹ In this context, market confidence means that ‘it is safe’ for investors to participate in a certain financial market. The importance of market confidence is fundamental in order to design a rationale for the regulation of CRAs.

⁵² Joshua D. Coval, Jakub W. Jurek and Erik Stafford, ‘Economic Catastrophe Bonds’ (2009) 99 *American Economic Review* 3, 628-629. The authors observe that ‘credit ratings describe a security’s expected payoffs in the form of its default likelihood and anticipated recovery value given default. However, because they contain no information about the state of the economy in which default occurs, they are insufficient for pricing’. See also Joshua D. Coval, Jakub W. Jurek and Erik Stafford, ‘The Economics of Structured Finance’ (2009) 23 *Journal of Economic Perspective* 1, 4-5.

⁵³ Choi observes that ‘conflicts of interest and agency cost problems within securities

The central role of ratings is to increase transparency in the financial markets by reducing the information asymmetry between issuers and investors. These concerns could determine a market failure if they are not adequately corrected by intervention on the part of the regulators.

The first reason provided above for the inaccuracy of ratings, namely ‘conflicts of interest’ can be explained as a species of strategic behaviour in the issuer-credit ratings relationship and clearly emerges in the mechanism of the ‘issuer-pays’ model. The issuer fees characterize the compensation system. Thus, the most common conflict of interest is in the revenue received by CRAs from the issuers that they rate.⁵⁴ This scheme inevitably fosters an incentive to over-rate in order to secure a high fee and inflated ratings.

A possible solution to this practice would rely on constraining rating fees. In order to mitigate this problem, it would be necessary to divorce issuer payment of the CRA from issuer selection of the CRA or encourage an alternative subscriber-pays market for ratings.⁵⁵ In other words, a system of standardized revenues could be put in place in order to reduce reliance on the ‘issuer-pays’ business model.

This research seeks to show that an ‘investor-pays’ model or ‘subscriber-pays’ model could be set up to address the question of conflicts of interest.

The second area that adversely affects the accuracy of ratings is better described by the fact that it can be argued that only three main CRAs (S&P’s, Moody’s and Fitch) operate in the entire financial market. It is enough for one agency to become lax and unscrupulous in its rating activities for this to have negative consequences on the prediction of default events. Most investors rely heavily on these agencies, which makes for a *de facto* oligopoly and increases the chances of inaccuracy of forecasting.

This problem is closely connected with the position and role of consumers (usually considered the weaker party to the transaction) because they are disadvantaged by the trading practices of suppliers.⁵⁶ In academic circles, a

intermediaries are examples of problems with potential market-based solutions’. See Stephen Choi (note 40) 72.

⁵⁴ Steven L. Schwarcz, ‘Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown’ (2008) 93 *Minnesota Law Review* 2, 401. The author observes that ‘rating agencies are customarily paid by the issuer of securities, but investors rely heavily on their ratings. This is technically a conflict, but it is not usually a material conflict because ratings are made independently of the fee received’.

⁵⁵ John C. Coffee Jr. (note 47) 49.

⁵⁶ Joanna Benjamin, *Financial Law* (Oxford: OUP 2007) 563. The author argues that consumers

proposal has been made that competition should be encouraged by enacting an ‘equal access’ rule under which issuers would be required to disclose their data publicly.⁵⁷ Chapter two discusses whether the equal access approach would ensure greater competition among the main CRAs and incentivize smaller credit rating agencies to enter the US Nationally Recognized Statistical Rating Organization (NRSRO), a special designation body with functions of authorization, registration and control of CRAs.

However, fair competition contains the prices that suppliers can charge and therefore restricts their profits. It exerts pressure on them to reduce costs, thereby rendering the enterprise productively more efficient. It also obliges the suppliers to respond to consumer expectations about quality.

The third aspect, namely reluctance to make disclosure, was the third reason mentioned in connection with the inaccuracy of ratings. It is related to the ‘appropriate’ information disclosed by CRAs on their rating methodologies. This concern involves the risk of informational asymmetries between issuers and consumers.

It is generally considered that this lack of equality in information disclosure—one of the principal causes of market failure⁵⁸—brings about an imbalance of information between parties to trade (one so severe that exchange is impeded) and that its effects justify regulatory intervention by the institutions. In economic literature, informational asymmetries represent a situation where the capital receivers are in the position of having more knowledge about the prospects and condition of the corporation than the capital suppliers, and are thus in a position to abuse this advantage.⁵⁹ There is an ensuing market failure in enhancing rating quality. This is due to a lack of competition and hence effective reputational discipline for getting it wrong.

are ‘classes of person deemed to be economically weak’.

⁵⁷ John C. Coffee Jr. (note 47) 5.

⁵⁸ Francis M. Bator (note 44) 351-352.

⁵⁹ George Akerlof, ‘Market for Lemons: Quantitative Uncertainty and the Market Mechanism’ (1970) 84 *Quarterly Journal of Economics* 3, 490; Hayne E. Leland and David H. Pyle, ‘Informational Asymmetries, Financial Structure, and Financial Intermediation’ (1977) 32 *The Journal of Finance* 2, 371; Michael Rothschild and Joseph E. Stiglitz, ‘Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information’ (1976) 90 *Quarterly Journal of Economics* 4, 648; Joseph Stiglitz, ‘Incentives, Risk and Information: Notes Toward a Theory of Hierarchy’ (1975) 6 *Bell Journal of Economics* 2, 552.

It is manifest that the party with superior information about the probability of default can opportunistically use it to induce the other party (issuer) into unexpected and undesired outcomes. However, ‘once the oligopolists’ grip is loosened, there will be no shortage of analysts ready to take their place. Clients may hesitate to use unknown newcomers, but veterans of the big three should capture business’.⁶⁰

After providing a critical analysis of the main issues associated with the CRAs’ activities, the next section advances a set of reforms for improving the transparency of credit rating agencies’ assessments.

1.4 *Suggested proposals*

As discussed in the previous section, adequacy of disclosure is a gauge to determine what an investor knew or should have known, based on the information available to it. Public disclosure of rating procedures and historical performance data on accuracy should enhance transparency and comparability of ratings. As MacNeil observed, ‘enhancing transparency of rating information would permit investors to look more closely into the “black box” of the rating process, thereby assisting them in understanding the ratings and facilitating due diligence on their own part’.⁶¹ In order to improve due diligence (for instance, investigations as to the suitability of rating models), independent experts, such as compliance officers, could be appointed. This type of third party services could prove to be a strong incentive to issue accurate ratings.

A compliance department tasked with measuring the historic performance of ratings and verifying their methodologies could check the impartiality and independent approach of rating agencies and disclose all information about rating procedures. In addition, the compliance officer could provide enhanced internal control mechanisms by ensuring that developments in the business and specific obligations meet the required standards of legality and integrity.⁶²

In this regard, the establishment of an internal control mechanism for the ratings procedures could encourage companies to operate under market incentives

⁶⁰ ‘Redeeming ratings’ *Financial Times* (London, 10 November 2011).

⁶¹ Iain MacNeil (note 19) 200.

⁶² Caitlin M. Mulligan, ‘From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors’ (2009) 50 *Boston College Law Review* 4, 1300-1301.

such as transparency and fairness. In particular, an on-going compliance programme may solve the monitoring problems (e.g, when agents cannot verify a firm's monitoring *ex ante*).⁶³ This type of regulatory approach should improve the governance of the CRAs and their legal duties to avoid and interdict the offences. This concept raises once again the thorny question of gatekeepers' liability in relation to their duties.⁶⁴

In order to consider this concept, it is necessary to investigate the opportunistic behaviour of CRAs in respect of issuers because of their potential collusive actions. Further, this analysis aims to verify whether this collusive behaviour faces a problem of cooperation, and whether this cooperation produces mutual gains for those who participate therein.⁶⁵

The opportunistic behaviour of rating agencies and issuers may be exacerbated by CRAs' governance where there are different parties with different interests in the outcomes of transactions. In order to tackle these issues, the research considers the implications of the *principal-agent* theory so as to investigate the extent to which conflicts of interest and information asymmetries exist between the issuer, the ratings agency and investors.⁶⁶

Assuming the *principal-agent* theory⁶⁷, this research explains how to recast the rating agencies-investors relationship. However, the issuer-agency relationship that exists between the issuer and the CRA raises questions from regulators and

⁶³ Jennifer Arlen and Reiner H. Kraakman, 'Controlling corporate misconduct: an analysis of corporate liability regime' (1997) 72 *New York University Law Review* 4, 766-767.

⁶⁴ It has been observed that 'its enforcement potential depends not only on the offense and the level of culpability that triggers personal liability, but also on the choice of gatekeepers and upon the design of their duties'. On this point see Reiner H. Kraakman (note 8) 892.

⁶⁵ This cooperative behaviour is addressed by the 'repeated game theory' in which it is explained why people engage in actions which produce joint benefits greater than private costs in two-person relationships. See Eric A. Posner, *Law and Social Norms* (Boston: Harvard University Press 2000) 18.

⁶⁶ Tony Van Gestel and Bart Baesens, *Credit Risk Management* (Oxford: OUP 2009) 124. In particular, the authors point out that 'the issuer credit rating is an overall judgement of the obligor's ability to meet his financial commitments. Issuer credit ratings reflect the issuer's fundamental credit risk, hereby making abstraction of security-specific differences related, e.g., to seniority, collateral, and/or guarantees'.

⁶⁷ According to the economic literature, a principal-agent problem occurs when one individual engages a skilled person to undertake some profit-making, or other utility-conferring activity. Typically, because of the principal's lack of expertise, a significant incentive to interact in imperfectly competitive environments is conferred on the agent, with the risk that the latter may opportunistically exercise that discretion in a way which maximizes his or her own interests, rather than those of the principal. The regulation can constrain the relationship between principal and agent, but fails to prevent opportunistic behaviour. In other words, the principal-agent problem is intended as 'a contract that gives the agent the incentives to manage the asset in the best way for the principal'. See Robert Cooter and Thomas Ulen, *Law & Economics* (5th edn, Pearson International Education 2008) 147.

investors.⁶⁸ In particular, issuers (principals) without sufficient information or expertise to implement their preferences employ agents (CRAs) who possess such expertise. Unless constrained (for example, by more focused regulation), agents may be able to exploit their discretion so as to advance their own interests, rather than those of their principal. Indeed, the agent may sacrifice the best interests of both investors and issuers for the agent's own personal self-interest. In this context, criticisms have arisen over the inability of CRAs to assess the market risk of structured financial products.⁶⁹

A closer examination of the issuer-agency relationship will enable some proposals to be advanced regarding the need of protection for consumers: the most effective way of solving the *principal-agent* problem in the credit rating sphere might be to realign the interests of the issuers and agencies.

CRAs may be concerned to further their interests not only in relation to issuers but also to investors. The agency problem facing credit ratings is connected with the need of issuers to develop a reputation for credibility. Fully-informed investors should provide a natural disciplining influence on poorly-performing credit ratings.

Some commentators have argued that 'gatekeepers [like CRAs] have an incentive to disappoint buyers only when the resulting gains exceed the costs of building a reputation. However, if sellers often find "cheating" to be profitable, buyers will discount the value of the reputational signal accordingly—and in extreme cases, the reciprocal expectations that support reputation will collapse under the weight of moral hazard'.⁷⁰ Through their individual reputations, gatekeepers have the power to influence the product value and pressure the expectations of market participants. On this view, gatekeepers should be directly responsible to investors for their performance.

According to Coffee, the gatekeepers fail to report to a principal, which results in a situation of conflict of interests.⁷¹ In substance, the issuer wants the inflated

⁶⁸ Gillian Tett, 'E-mails throw light on murky world of credit' *Financial Times* (London, 25 April 2010).

⁶⁹ Committee on the Global Financial System, 'Ratings in structured finance: what went wrong and what can be done to address shortcomings?' (July 2008) Committee on the Global Financial System Papers No 32, 3-5.

⁷⁰ According to Reiner H. Kraakman (note 8) 97. The author observes that 'reputations are particularly important where buyers cannot verify the quality of goods or services prior to their purchases, and enforceable warranties prove costly or ineffective'.

⁷¹ John C. Coffee Jr. (note 8) 335-337.

rating less for its impact on the market than for its ability to reduce its regulatory costs. However, the issuer may misrepresent the information supply to the gatekeeper, but this misconduct could be detected or prevented by an internal supervisory body. In this way, the involvement of independent controllers should address the inaccuracy of ratings and limit the scope of conflicts of interest between issuers and raters.

The introduction of a strong ‘principal’ to monitor the ‘agent’ should cost little and produce quantifiable benefits.⁷² Under this regime, liability rules could furnish a powerful incentive to strengthen the screening accuracy of CRAs.⁷³

In order to deal with these questions, this research seeks to argue that an adequate compliance function could certify both the accuracy of ratings assessments and the high quality of the financial product. Through the compliance function, CRAs may signal their value to investors because the reputational value of CRAs depends on the level of their screening accuracy. Consequently, the compliance officer could play the role of a new ‘agent’ for the purposes of monitoring ratings. In addition, the compliance function would have the incentive to control its agent (CRA) on the grounds of consumer protection. This would realign the *principal-agent* relationship. Investors should become the principal who hires and fires the gatekeeper.

In order to address these concerns, this research also provides an analysis of the governance of CRAs.⁷⁴ In particular, the concept of ‘efficiency’⁷⁵ is considered in order to explain the legal questions of CRA accountability.

⁷² *ibid* 338.

⁷³ John C. Coffee Jr., ‘Enhancing Investor Protection and The Regulation of Securities Markets’ (2009) Columbia Law and Economics Working Paper No 348, 69. In particular, ‘credit rating agencies must be compelled either to conduct reasonable verification of the key facts that they are assuming in their ratings methodology or to obtain such verification from professionals independent of the issuer’. For this obligation to be meaningful, it must be backstopped by a standard liability specifically designed to apply to credit rating agencies.

⁷⁴ This research uses simple concepts of law and economics to explain the strategic behaviour of CRAs and to address the major questions facing the issuer-agency relationship.

⁷⁵ In this research, the term ‘efficiency’ is identified in the sense of ‘allocative efficiency’ (i.e. the Kaldor-Hicks criterion). In the economic literature, the concept of efficiency can be regarded as the maximization of wealth of society (‘distributional efficiency’) or ‘allocative efficiency’ (or ‘Pareto efficiency’) concerning with the amount of welfare within a given society and an efficient policy is one which maximizes that amount (the satisfaction of individual preferences). A particular situation is ‘Pareto efficient’ where the benefit of one individual cannot be improved without reducing the benefit of any other member of society. See Richard A. Posner, *Economic Analysis of Law* (Wolters Kluwer Aspen Publisher 2007) 11-15.

After providing and discussing proposals to ameliorate the major deficiencies of CRAs' governance, the following section focuses on the issues regarding the failures of CRAs.

1.5 Rating agencies' failures and remedies

CRAs have been accused of giving more weight to political rather than economic factors. They have also been accused of getting their timing wrong (for example, the warnings of downgrading of members of the Eurozone in the 2007-2009 financial turmoil).⁷⁶ In other words, CRAs have often been more successful at confirming risk but less good at risk prognosis. Policymakers' reliance on credit ratings increased during the current sovereign debt crisis (particularly during the Greek crisis in 2011-2012), where rating downgrades led to market losses for countries, together with adverse effects such as the rapid drying up of liquidity.⁷⁷

Credit rating firms have been criticized, not only for issuing inaccurate ratings to subprime mortgages⁷⁸ leading up to the financial crisis, but also for weaknesses in their internal controls and procedures for managing conflicts of interest, including firm policies on securities trading.⁷⁹

Empirical studies have shown internal control weaknesses in respect of corporate debt ratings.⁸⁰ In this regard, a proposal has been made 'to establish an independent assessment institution to assess the accuracy of CRA estimates of probability of default, and to publish comparative studies of such accuracy'.⁸¹

⁷⁶ 'S&P credit warning provokes outrage' *Financial Times* (London, 7 December 2011) 7.

⁷⁷ The current financial crisis has revealed the huge role played by CRAs in the rapid growth of structured products markets. In fact, structured products require a targeted rating that considerably involves the assessment process of credit agencies.

⁷⁸ A subprime mortgage can be defined as a loan made to a borrower who has poor credit and would be disqualified from prime or near-prime mortgages. During the 2007-2009 financial crisis, subprime mortgages assumed a significant role because the loans were bundled and sold as structured products called collateralized debt obligations. See Markus K. Brunnermeier, 'Deciphering the Liquidity and Credit Crunch 2007-2008' (2009) 23 *Journal of Economic Perspective* 1, 82-83.

⁷⁹ Kara Scannell, 'SEC critical of rating agency's controls' *Financial Times* (London, 30 September 2011).

⁸⁰ Samir M. El-Gazzar, Kwang-Hyun Chung and Rudolph A. Jacob, 'Reporting of Internal Control Weaknesses and Debt Rating Changes' (2011) 17 *International Advances in Economic Research* 4, 421-425.

⁸¹ Charles A.E. Goodhart, 'How, if at all, should Credit Ratings Agencies (CRAs) be Regulated?' (June 2008) LSE Financial Markets Group Paper Series, Special Paper No 181, 25-26. See also Charles A.E. Goodhart, *The Regulatory Response to the Financial Crisis* (Cheltenham: Edward Elgar 2009) 129. In particular, the author suggests the establishment of a small independent body, a CRA Assessment Centre.

Notwithstanding some obvious benefits, a separately established independent authority would perhaps be too costly for the financial industry and would be less credible if it were to be directly controlled by the industry itself.

In the well-known corporate scandals that engulfed Enron, WorldCom and Lehman Brothers, these companies were given high ratings and investors relied on them. For instance, the Enron case clearly illustrates the dangers of such reliance.⁸² The CRAs belatedly downgraded them but only after holding off for a time. Coffee observed that ‘this pattern in which a ratings downgrade resembles more an obituary than a prophecy again suggests the absence of real competition’.⁸³ Investors piled into these seemingly high-growth companies; the CRAs downgraded their ratings, red-flagging them as increasingly high-risk.⁸⁴ This concern was considered to be negative by market participants because ratings changes appeared to be sluggish, inaccurate and with few incentives to be responsive to investors.⁸⁵

CRAs have no incentives to screen the accuracy of their assessment methodologies.⁸⁶ This stems from their performance with regard to the evaluation of financial-sector creditworthiness. The point is that rating agencies should establish a direct relationship with investors.

These corporate scandals underlined the need for improving the working methodology of CRAs. They also drew attention to the fallibility of the CRAs’ assessments, on which investors typically rely for protection without being conscious of disregarding the fact that a rating changes over time.⁸⁷ For instance,

⁸² Jeffrey N. Gordon, ‘What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections’ (2002) 69 *University of Chicago Law Review* 3, 1234-1235. See also John C. Coffee Jr. (note 11) 1409-1412.

⁸³ John C. Coffee Jr. (note 8) 285. The author observes that ‘rationally, the nominal competitors may prefer to enjoy the quiet life and not invest in the personnel or monitoring necessary to detect financial decline before it becomes public knowledge’.

⁸⁴ Andrew Hill, ‘Enron: see no evil, hear no evil, speak no evil’ *Financial Times* (London, 2 December 2011) 19. The author observes that ‘when the rating agencies downgraded Enron’s debt to junk in late November 2001 (they had been holding off in the hope a rival group might buy the energy trader; many Wall Street analysts still rated the company a “buy” or “strong buy”), it was bust within days’.

⁸⁵ William H. Beaver, Catherine Shakespeare and Mark T. Soliman, ‘Differential Properties in the Ratings of Certified vs. Non-Certified Bond Rating Agencies’ (2006) 42 *Journal of Accounting and Economics* 3, 310-312.

⁸⁶ John C. Coffee Jr. (note 73) 66-67.

⁸⁷ *ibid* 10-15. Coffee argues that two factors represent persuasive explanations for gatekeeper deterioration: (1) the rise of structured finance and the change in relationships that it produced between the rating agencies and their clients; and (2) the appearance of serious competition within the ratings industry that challenged the long stable duopoly of Moody’s and Standard & Poor’s and that appears to have resulted in ratings inflation.

in the Enron failure, gatekeepers certified the issuer's compliance with an inventory of highly technical rules—without the auditor necessarily taking responsibility for the overall accuracy of the issuer's statement of its financial position.⁸⁸ It has been argued that 'the gatekeeper's services have value only if the gatekeeper is certifying compliance with a meaningful substantive standard'.⁸⁹

In addition, the aforementioned corporate collapses (Enron, WorldCom, Lehman Brothers) raised questions about the conflict of interests of the CRAs that perform consultancy work for their clients.⁹⁰ In this regard, the securities industry has not settled the question as to whether CRAs should be liable for misrepresentations or fraud to issuers and investors.

The government initiatives (at the EU and US level)⁹¹ have sought only to improve the transparency and fairness of CRAs by creating a rigorous system of regulation and supervision that enables the ratings industry to deliver services considered indispensable while, as far as possible, preventing them from pursuing activities that are deemed detrimental to consumers.⁹²

The legal system set in place by the global regulators⁹³—IOSCO, Financial Stability Board (FSB), Group of Twenty (G-20) and Securities Industry and Financial Markets Association (SIFMA)—failed to create a proper normative framework for CRAs. This 'light touch' regime revealed weaknesses in addressing enforcement concerns.

A further pertinent question is the scarce enforceability of the self-regulation regime governing the CRAs (in respect to principles, recommendations and codes of conduct delivered by global regulators). CRAs are like the gatekeepers of the

⁸⁸ See John C. Coffee Jr. (note 11) 1416.

⁸⁹ *ibid* 1417.

⁹⁰ Stephanie Kirchgaessner and Kevin Sieff, 'Moody's chief admits failure over crisis' *Financial Times* (London, 24 April 2010).

⁹¹ At EU level, see Regulation (EU) No 462/2013 (OJ 2013 L 146 p. 1). At US level, see the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203 (Dodd-Frank Act 2010).

⁹² Gudula Deipenbrock and Mads Andenas, 'Regulating and supervising credit rating agencies in the European Union' (2012) 9 *International and Comparative Corporate Law Journal* 1, 1.

⁹³ Global regulators are generally considered 'informal regulators' since there is no formal legal framework that govern the responsibilities and the division of labour among them. These entities and bodies are involved in the process of setting international standards for financial markets commonly defined as a form of 'soft law'. See Mario Giovanoli, 'A New Architecture for the Global Financial Markets: Legal Aspects of International Financial Standard Setting' in Mario Giovanoli (ed), *International Monetary Law. Issues for the New Millenium* (Oxford: OUP 2000) 33. See also Chris Brummer, *Soft Law and the Global Financial System, Rule Making in the 21st Century* (Cambridge: CUP 2012) 74.

capital markets, so it is very important to look for an appropriate regulatory response.⁹⁴

As indicated earlier, ratings were under fire because of their inaccuracy in evaluating companies' creditworthiness and on account of the fact that the CRAs earned profits by selling regulatory licenses to issuers.⁹⁵ Paradoxically, these profits did not reflect the informational value of the ratings. The problem was that the main CRAs had become more profitable even as the quality of their ratings has collapsed.

From this perspective, 'regulatory dependence on ratings created higher demand for ratings and increasingly higher profits for NRSROs (nationally recognized statistical rating organizations), even when their ratings proved spectacularly inaccurate'.⁹⁶ For that reason legitimate concerns have been raised about the regulatory reliance on ratings because they increase the incentives to shop for ratings.

In this context, it may be noted that the reliability of CRAs is principally motivated by their experience and the reputation of rating agencies among investors. In fact, the gatekeeper is trusted to the extent that it is a repeat player who possesses significant reputational capital and information that would be lost or depreciated if it were found to have been involved in misconduct. Thus, the ratings market looks like an oligopoly with a small number of high profitable agencies that earn a consistently high rate of return.

This sort of oligopolistic market was increased by the NRSRO's and the Securities and Exchange Commission's policy of entitling only selected rating agencies to assess issuers' bonds. However, this sort of oligopolistic position of the main CRAs 'seems attributable instead to the high barriers to entry into this market, which require that a new firm acquire reputational capital before it can acquire clients'.⁹⁷ As Coffee observed 'this lack of competition permits these

⁹⁴ Gilian Tett, Jennifer Hughes and Aline Van Duyn, 'S&P unveils ratings overhaul' *Financial Times* (London, 7 February 2008).

⁹⁵ John Gapper, 'Let rating agencies have their say' *Financial Times* (London, 8 December 2011) 11, where it is observed that 'the agencies remain a protected species because central banks use ratings from officially approved agencies for purposes including deciding which collateral to take from banks and assessing the riskiness of assets'.

⁹⁶ Frank Partnoy (note 33) 190.

⁹⁷ John C. Coffee Jr. (note 47) 55.

nominal competitors to shirk, engaging in less effort and research than if there were true active competition'.⁹⁸

The reputational capital of CRAs has constituted a wire fence with respect to investors and regulators creating a huge gap in the information supply process. The credibility of CRAs has progressively taken the place of regulatory interventions of financial institutions.⁹⁹

The lack of a proper liability regime facilitates misstatements and negligence. These considerations underline the question as to whether CRAs should be subject to a system of civil liability.¹⁰⁰

In the on-going debate, a model has been proposed which combines the better incentives of strict liability with a system that: (1) places a realistic ceiling on the gatekeeper's aggregate liability; and (2) minimizes the transaction costs associated with enforcement.¹⁰¹ This proposal subordinates compensation to deterrence, but only with regard to litigation against gatekeepers, who are seldom in any event in a position to fund full compensation to the class of investors and consumers.¹⁰²

Another commentator has characterized ratings as a form of investment recommendations on the premise that '*de facto* they may perform a similar function to recommendations by influencing (through regulatory and contractual linkages) the financial instruments that are held by financial institutions'.¹⁰³ On this view, ratings should be subject to an equivalent regulatory regime as investment recommendations. However, the disclaimers often used by the leading CRAs (namely S&P's, Fitch and Moody's) that ratings are merely simple opinions may constitute an obstacle to regulating the credit rating agencies as a purveyors of recommendations (see 'Appendix IV').

⁹⁸ John C. Coffee Jr. (note 8) 285.

⁹⁹ Mathias Audit, 'Aspects internationaux de la responsabilité des agences de notation' (2011) 100 *Revue critique de droit international privé* 3, 582-585.

¹⁰⁰ It may seem surprising because the rating agencies enjoy a virtual immunity from private litigation. The recent cases have shown a reluctance to impose civil liability on CRAs. See, in particular, *Jefferson County Sch. Dist. v Moody's Investor services, Inc.* [1999] No 97-1157; *Compuware Corp. v Moody's Investor services, Inc.* [2007] No 05-1851; and *Newby v Enron Corporation* [2005] 511 F. Supp. 2d 741.

¹⁰¹ John C. Coffee Jr. (note 23) 459. The author observes that strict liability coupled with a ceiling can produce adequate deterrence without necessarily exceeding the boundaries of political feasibility.

¹⁰² Frank Partnoy, 'Strict Liability for Gatekeepers: A Reply to Professor Coffee' (2003) University of San Diego School of Law, Law and Economics Research Paper, 3.

¹⁰³ Iain MacNeil (note 19) 197.

A viable suggestion has been proposed by Partnoy on the basis that strict liability could be imposed on gatekeepers, such as CRAs, for material misstatements and omissions in offering documents while removing any due diligence-based defences from securities regulation.¹⁰⁴ According to Partnoy, the advantage of imposing strict liability on gatekeepers would be that it would incentivize transparency and fairness.¹⁰⁵ However, this would not afford a solution in terms of responsibility to investors, i.e. customers. A strict liability regime would be effective only with respect to the issuer, leaving the question of losses incurred by the investor unresolved. In addition, strict liability could be a potentially costly way of inducing gatekeepers to clamp down on client misconduct.¹⁰⁶

According to Coffee's view, 'the gatekeeper could be held liable even when the issuer is not'.¹⁰⁷ In particular, this perspective assumes that the gatekeeper has failed in his responsibility to unearth the irregularity and should not be absolved because the issuer's conduct was only negligent, rather than fraudulent.

What is central to Coffee's position is the 'adverse selection' problem. This means that 'if gatekeepers cannot distinguish *ex ante* the "honest" from the "dishonest" issuer, a lemons market developed under strict liability should logically drive the honest client from the market'.¹⁰⁸

In economic literature, the theory of the 'lemons market' was developed by Akerlof in the early 1970s to exemplify the interaction of quality differences and uncertainty, in particular the presence of markets in which buyers use market statistics to judge the quality of prospective purchases.¹⁰⁹ By taking as an example

¹⁰⁴ Frank Partnoy (note 32) 540. According to Partnoy's proposal, a gatekeeper is strictly liable for a percentage of the securities fraud damages that the issuer pays. Partnoy also argues that 'the ex post costs of litigating securities disputes against gatekeepers would be almost entirely eliminated'.

¹⁰⁵ *ibid* 542.

¹⁰⁶ Assaf Hamdani, 'Gatekeeper liability' (2003) 77 *Southern California Law Review* 1, 60. The author argues that 'holding gatekeepers strictly liable will not guarantee that clients enter the market only when it is socially desirable to do so'. Precisely, if strict liability is not superior in inducing gatekeepers to police client conduct, there is no justification for favouring it over other forms of liability (at 84). According to Hamdani's view, gatekeeper liability determines an inevitable trade-off between preventing misconduct and minimizing the disruption of market access. In these terms, no regime of gatekeeper liability is likely to produce the first-best outcome. This underscores the limited usefulness of gatekeeper liability as an instrument of social policy aimed at preventing misconduct (at 106).

¹⁰⁷ See John C. Coffee Jr., 'Partnoy's complaint: a response' (2004) 84 *Boston University Law Review* 2, 377-382.

¹⁰⁸ *ibid* 380.

¹⁰⁹ George Akerlof (note 59) 488.

the model in automobile, this theory discusses the existence of the ‘incentive for sellers to market poor quality merchandise, since the returns for good quality accrue mainly to the entire group (whose statistic is affected) rather than to the individual seller’.¹¹⁰ As Akerlof noted, the automobiles’ market is preferred for its concreteness and ease in understanding rather than for its importance or realism.¹¹¹

Therefore, a strict liability regime is justified only if it can address the CRA-investor relationship. Such a liability regime may go a long way to remedy perceived negligence and poor services.¹¹² This type of liability system may contribute towards the preservation of the CRAs’ reputational capital: however, without specific legislation introducing such liability, it is hard to see how a case could be brought against the rating agencies for liability. In this light, the ratings assessment could be more effectively regulated both through internal controls and hard-law measures.¹¹³

This research argues that a mixed regime that includes elements of both liability and compliance activities could be a favourable one for CRAs.¹¹⁴ Such a mixed liability regime could improve the credibility (i.e. reputation) of CRAs by implementing measures such as monitoring, investigating, and reporting misconduct.

After examining the rating agencies’ failures in high-profile, recent corporate collapses and their inaccuracy in evaluating companies’ creditworthiness, the next section outlines the CRAs’ regulatory reforms at the European level. In doing so it takes account of the major concerns associated with the CRAs’ assessment activity.

¹¹⁰ *ibid* 488.

¹¹¹ *ibid* 489.

¹¹² Mia Mahmudur Rahim, ‘Credit rating agencies’ roles have to be reassessed’ (2010) 4 *Law and Financial Markets Review* 4, 435.

¹¹³ Rosa M. Lastra and Geoffrey Wood, ‘The crisis of 2007-09: nature, causes and reactions’ (2010) 13 *Journal of International Economic Law* 3, 547-549. The authors identify ‘five groups’ of regulatory responses: (1) substance of regulation; (2) structure of supervision and regulation; (3) behaviour of the banking industry and bank managers; (4) fiscal side; and (5) bank structural reforms.

¹¹⁴ This analysis intends to extend the proposal argued by Arlen and Kraakman. See Jennifer Arlen and Reiner H. Kraakman (note 63) 691-694. The authors suggest—in a corporate governance environment—a mixed entity liability regime that combines aspects of strict liability together with duty-based liability. In substance, this regime includes (1) modified forms of strict liability that are adjusted to induce firms to adopt policing measures; and (2) ‘composite’ liability regimes that combine monitoring and reporting duties with a residual element of strict liability to induce preventive measures and regulate activity levels.

1.6 *The regulatory reforms*

The key to a successful deal for a corporate issuer is securing the right credit rating. It is evident that companies and investment banks are not simply market-makers, or disinterested parties acting on behalf of clients. The interest to promote risky products and complicated financial schemes is the core business of securities' issuers.

In the US, an SEC investigation revealed that prominent investment banks had bundled 'toxic mortgages into complex financial instruments, managed to persuade the credit rating agencies to label them as "AAA" securities, and sold them to investors, magnifying and spreading risk throughout the financial system, and all too often betting against the instruments they sold and profiting at the expense of their clients'.¹¹⁵ What is more, one of the main players in the credit rating market was notified by the SEC that it could face civil charges on the ground that it had violated Federal securities laws in connection with its rating of a structured finance vehicle before the crisis.¹¹⁶

In substance, CRAs were accused of having made unrealistic assumptions about structured finance products in order to issue "AAA" ratings.¹¹⁷ CRAs claimed that their assessment does not explicitly address market pricing or trading liquidity for the security in question, but rather focuses on the likelihood of a default.

Another question is the fact that the few main CRAs provide ratings that have become too deeply embedded in the regulatory capital assessment system. Ratings are considered to be a measure of risk for regulatory capital, i.e. credit and market risk under the Basel framework, and their use influences the determination of capital requirements of financial firms. It is argued that 'the greater the leverage within those firms, the greater will be the effect of changes to ratings on capital

¹¹⁵ United States Senate Permanent Subcommittee on Investigations, 'Wall Street and the Financial Crisis: Anatomy of a Financial Collapse' (13 April 2011) 6-7.

¹¹⁶ On September 22, 2011, The McGraw-Hill Companies, Inc. received a 'Wells Notice' from the Staff of the SEC stating that the Staff is considering recommending that the Commission institute a civil injunctive action against Standard & Poor's Ratings Services, then a division of The McGraw-Hill Companies, Inc., alleging violations of federal securities laws with respect to S&P's ratings for a particular 2007 offering of collateralized debt obligations, known as 'Delphinus CDO 2007-1'. See Kara Scannell and Shannon Bond, 'SEC in court threat to S&P over financial crisis' *Financial Times* (London, 26 September 2011).

¹¹⁷ Financial Crisis Inquiry Commission, 'The Financial Crisis. Inquiry Report', Final Report of the National Commission on the causes of the financial and economic crisis in the United States (January 2011).

requirements'.¹¹⁸ Many investors have mandates that only allow them to invest in securities that have a certain rating such as 'AAA'. It should be reiterated that the *raison d'être* of CRAs is to offer an opinion on the likelihood of debt instruments being repaid, which is a legitimate activity. Issuers pay for ratings because, in the long run, this deepens the pool of investors.

The underlying problem is how well CRAs fulfil their responsibilities. Rating agencies' activities suggest a clear degree of independence from issuers. The crux of the matter is 'because rating agencies make their rating determinations based primarily on information provided by the issuer of securities, a rating is no more reliable than that information'.¹¹⁹

It is clear that the 'certification' role of CRAs underlines the reliance which is placed in their gatekeeper function. Because CRAs' influence market prices, not only in terms of disclosure information, but also in terms of outlooks, reviews and watches/warnings, CRA views have impacted on investment grades.

An option to prevent CRAs exerting such power could be to stop promoting them or to motivate institutional investors to look for alternative sources of credit information. Such an option stems from the fact that 'the increased reliance on ratings reduced the reputational constraints on credit-rating agencies'.¹²⁰ The prospect of this option coming to fruition could help to open the ratings market and stimulate the leading CRAs to improve their performances.

This research sets out to demonstrate that 'reputational capital' and reputation alone are not a workable constraint on gatekeeper certification. It further postulates that it is necessary to bolster the ratings service with an independent oversight regime in order to help manage the complex global regulatory landscape and improve dialogue with investors, regulators and the public.¹²¹

Consumers are often unable to draw inferences about the reputation and reliability of the rating agency when an assessment takes place. CRAs should enhance the quality (and volume) of the information available to consumers. In other words, investors should be ensured of the appropriate level of information

¹¹⁸ Iain MacNeil (note 19) 186.

¹¹⁹ Steven L. Schwarcz, 'The Role of Rating Agencies in Global Market Regulation' in Eilís Ferran and Charles A E Goodhart (eds), *Regulating Financial Services and Markets in the Twenty First Century* (Oxford: Hart Publishing 2001) 299.

¹²⁰ Frank Partnoy (note 35) 441.

¹²¹ Dalvinder Singh and John Raymond LaBrosse, 'Developing a Framework for Effective Financial Crisis Management', University of Warwick School of Law, Legal Studies Research Paper No 2012-05, 9.

on which to base their decisions. Notwithstanding the quality of information, it is evident that some individual investors are unskilled and take poor decisions about risk even when they have full information about the products at their disposal.

As a result, the question of the reliability of credit ratings and the influence of the main rating agencies constitute major areas of concern in the financial sector.

The CRAs fail to give a convincing answer to fundamental questions: to what extent do their activities contribute to market confidence and are indispensable to the growth of the financial sector? This latter question is a central one that this work addresses. The 2007-2009 financial turmoil has provided much ammunition for opponents of the CRAs, but looking at the evolution of credit ratings the only surprise is that it took so long before any serious concern materialized.

As noted earlier in this chapter, securities regulation has recently sought to restore confidence in CRAs by striving to fill the major gaps in ratings' governance. The regulation centres chiefly on the conflicts of interest arising from the 'issuer-pays' model and the methodology and data sources used by CRAs.

At the EU level, the European Commission set out a vast programme to re-regulate the CRAs in which it sought to address the major concerns, such as the limited competition in the market for credit ratings, rating agency independence and the agencies' activities.¹²² As Moloney noted 'rating agencies can be regarded as pathfinders in terms of operational harmonization, substantive harmonization, and the centralization of supervision'.¹²³

The Commission proposed that issuers should be required to rotate the agencies that rate government bonds.¹²⁴ The idea was to prevent the incumbent

¹²² European Commission, 'Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EC) No 1060/2009 on credit rating agencies', COM(2010) 289 final; European Parliament, 'Resolution of 8 June 2011 on credit rating agencies: future perspectives', (2010/2302(INI)) and Regulation No 513/2011 of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies. Also, the Commission issued a proposal amending Regulation (EC) No 1060/2009 (COM(2011) 747 final) and a proposal amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings of collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of the excessive reliance on credit ratings (COM(2011) 746 final).

¹²³ Niamh Moloney, 'Reform or revolution? The financial crisis, EU financial markets law, and the European Securities and Markets Authority' (2011) 60 *International and Comparative Law Quarterly* 2, 525.

¹²⁴ In particular, the EU proposal attempted to overhaul the ratings industry and force issuers to rotate the rating agency they use at least every three years, and in some cases every year. See Alex Barker, 'Rating agencies seek to block EU reform' *Financial Times* (London, 6 November 2011). The powerful lobbying deployed against similar proposals for auditing firms shows the sort of resistance that the Commission can expect also in the case of CRAs.

agency's analysts from becoming too 'overfamiliar' with issuers and therefore too lenient. In addition, the Commission proposed that issuers of financial products should be forced to change the rating agency they are using more regularly. This aimed to open up competition and avoid conflicts of interest.¹²⁵

This research discusses in Chapter three the reforms proposed giving wide-ranging powers to the European Securities and Markets Authority (ESMA) to approve ratings methods and ban sovereign ratings in 'exceptional situations' (or in 'inappropriate moments').¹²⁶ Specifically, the ESMA is empowered to suspend the credit ratings of countries receiving emergency financial assistance.¹²⁷ However, it was claimed that 'any ability for ESMA to suspend sovereign ratings may damage the independence of the credit rating agencies in the eyes of the financial markets'.¹²⁸

By the same token, it was proposed at the EU level that credit rating agencies could be barred from downgrading countries in the Eurozone bailout scheme.¹²⁹ In this respect, if a CRA is described as a thermometer of financial crisis 'it is not the thermometer that causes the fever, but the thermometer has to work properly to ensure you do not exaggerate the fever'.¹³⁰ However, the CRA issues ratings that

¹²⁵ On 24 January 2012, the hearing held by the European Parliament's ECON Committee provided a comprehensive state of play of the positions on Credit Rating Agencies after the proposed draft regulation and directive on CRA III was adopted on 15 November 2011. The draft proposal had four main objectives: (1) to reduce over-reliance on ratings: the draft regulation requires the ESAs to reduce reliance on ratings when drafting technical standards and the draft directive addresses over-reliance from UCITs and AIFM; (2) to increase transparency on sovereign debt, with requirements regarding the frequency of ratings and on timing; (3) to enhance competition and reduce conflicts of interest, through the introduction of a rotation principle and of rules regarding cross-ownership; and (4) to introduce a civil liability regime for CRAs in case of gross negligence or intentional infringement of the Regulation. See European Parliament Committee on Economic and Monetary Affairs, 'Public Hearing on Credit Rating Agencies', Brussels, 24 January 2012.

¹²⁶ According to Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies (OJ 2013 L 146 p. 1), ESMA can conduct investigations, ongoing inspections and impose fines directly on credit rating agencies that breach European Union rules. See Nikki Tait, 'EU body empowered to fine rating agencies' *Financial Times* (London, 3 December 2010).

¹²⁷ Alex Barker, 'EU shake-up for rating agencies' *Financial Times* (London, 20 October 2011).

¹²⁸ AFME, 'AFME comment on the European Commission's proposals for Credit Rating Agencies' (Press Release, 16 November 2011) <<http://www.afme.eu>> accessed 17 November 2011.

¹²⁹ Eilís Ferran, 'Crisis-driven regulatory reform: where in the world is the EU going?' in Eilís Ferran, Niamh Moloney, Jennifer G. Hill, John C. Coffee, Jr (eds), *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge: CUP 2012) 13-14.

¹³⁰ Michael Barnier, 'Commission wants better quality credit ratings', European Commission, Press release, Brussels, 15 November 2011.

are an ordinal measure of the creditworthiness of a debtor this means that ‘ratings are not temperature readings but weather forecasts’.¹³¹

Some European countries have been extremely critical of the manner and timing of certain sovereign debt rating decisions taken during the 2010-2012 Eurozone crisis, although the CRAs have defended their conduct.¹³² Other proposals included the establishment of a new independent ratings agency and different models to mitigate conflicts of interest in the current ‘issuer pays’ model. However, these proposals will more likely prove to be ineffectual because rating methods necessarily evolve over time to reflect innovations by underwriters, new legislation and changes in the financial market.

These proposals constituted the ground for the adoption of Regulation (EU) No 462/2013.¹³³ This legislation addressed two of the major concerns of the ratings industry firstly, the near-total domination of the market by the main three rating agencies; and, secondly, the dubious issuers-rating agencies relationship.

In this context, it should be noted that members of the European Parliament called on the European Commission to establish a public European CRA that would produce impartial ratings without being constrained by commercial considerations.¹³⁴ The European Parliament also suggested looking at the possibility of establishing a network of smaller European rating agencies, in an effort to bring more competition into the industry.¹³⁵ But this proposal had already been greeted with a considerable amount of scepticism, not least because of the perceived lack of independence of such an agency.

Concerns about rating ‘downgrading’ have made CRAs unpopular, in particular on account of the inconvenient timing of their published opinions.¹³⁶

¹³¹ Dan Hanquist, ‘The importance of Being and of Being Earnest: Ontological, Epistemological and Constitutional Aspects of Credit Ratings’ in Jan Kleineman, Lars Gorton and Aron Verstandig (eds), *Perspectives on Credit Rating Agencies* (Stockholm: Författarna, Stockholm Centre for Commercial Law Jure Förlag AB 2013) 182. See in the same vein Iain MacNeil (note 19) 179, footnote 3, where it is observed that ‘ratings provide an ordinal measure which does not seek to measure the distance between two variables. The medals awarded in the Olympic Games are a classic example’.

¹³² Alex Barker, ‘A glimmer of hope for credit rating agencies’ *Financial Times* (London, 11 November 2011).

¹³³ Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies (OJ 2013 L 146 p. 1).

¹³⁴ European Commission, *Public Consultation on Credit-Rating Agencies*, 5 November 2010. See also Geraldine Lambe, ‘CRA: regulation with bite or toothless?’ *The Banker* (London, June 2011).

¹³⁵ Nikki Tait, ‘Brussels faces rating agency dilemma’ *Financial Times* (London, 7 July 2011).

¹³⁶ As the EU Commissioner for Internal Market and Services, Michel Barnier, noted, “I have also been surprized by the timings of some sovereign ratings—for example, ratings announced in the

Financial institutions are still searching for an appropriate solution for a *modus operandi* of CRAs. However, criticisms of rating agencies are entirely legitimate where their predictions seem to suggest that they may be motivated by some speculative intent.¹³⁷

Moreover, speculation about rating agency downgrades of countries' sovereign debt influences trading on the markets. Notwithstanding this, the main rating agencies claim that this is an inevitable consequence of issuing independent opinions, and that opinions are only one measure of risk.

This research sets out to show that downgrades are not only a reflection of reality but also a provision of ground-breaking new information about the speculative effects of the downgrades on the markets. CRAs should face a lagging indicator rather than a leading one. They should verify the market's judgement rather than lead it.

Cantor and Mann have argued that there is a trade-off between rating evaluations and market stability.¹³⁸ Empirical studies have identified that the focus of agencies on long investment horizons explains only part of the relative stability of agency ratings.¹³⁹ Further, other academic studies have shown a possible balance between rating stability, rating timeliness and default prediction performance.¹⁴⁰

If the role of CRAs is solely to forecast the creditworthiness of financial instruments, it is possible to point to an imbalance between downgrade evaluations and market confidence. As Coffee observed 'as gatekeepers, the credit

middle of negotiations on an international aid programme for a country". Barnier also claimed that "Ratings have a direct impact on the markets and the wider economy and thus on the prosperity of European citizens." "They are not just simple opinions." See BBC, 'EU targets credit rating agencies', 15 November 2011 <<http://www.bbc.co.uk/news/business-15739234>> accessed 10 June 2013.

¹³⁷ Bo Becker and Todd Milburn, 'How did increased competition affect credit ratings?' (2009) Harvard Business School, Working Paper No 09-051, 10.

¹³⁸ Richard Cantor and Christopher Mann, 'Analyzing the Tradeoff Between Ratings Accuracy and Stability' (2007) 16 *The Journal of Fixed Income* 4, 60-64.

See also Kara Scannell, 'SEC makes S&P downgrade inquiries' *Financial Times* (London, 11 August 2011) and Tobias Buck, 'Rating agencies hit by subprime probe' *Financial Times* (London, 16 August 2007).

¹³⁹ Edward I. Altman and Herbert A. Rijken, 'How rating agencies achieve rating stability' (2004) 28 *Journal of Banking and Finance* 11, 2679-2680.

¹⁴⁰ Edward I. Altman and Herbert A. Rijken, 'The effects of rating through the cycle on rating stability, rating timeliness and default prediction performance' (2005) New York University Working Paper No FIN-04-032, 26-27.

rating agencies did not monitor clients closely after the point of their initial rating. Thereafter, rating downgrades generally followed the market, rather than led it'.¹⁴¹

One key concern is whether rating downgrades may destabilize financial markets, particularly when downgrades cross into non-investment grade categories. As indicated earlier, the information provided by CRAs is regarded as being a public good. Consequently, CRAs should supply information freely, not only to issuers who have paid for it (and can benefit from this information), but also to investors that rely on it.

By keeping a record of the outcome of their rated instruments, CRAs provide a public service. In this regard, it has been argued that 'a rating is valuable only if everybody knows it, and you cannot get an investor to pay for information he already has. Ratings are a public good that have two possible paymasters: government or issuers'.¹⁴² Since regulators use them, regulators could pay for the use of CRAs' information. Investors—as market participants—should be made aware of the uncertainties surrounding future predictions of default events. So there is a public interest in generating accountability for this publication of results.

After considering the regulatory reforms proposed at the EU level and the relevant issues related to CRAs' judgements, the following section illustrates the purpose of the research indicating some remedies intended to enhance the normative framework for CRAs.

1.7 *Aim of the research*

The aim of the research is to underline the weakness of the present regulatory regime for CRAs and to posit some viable changes designed to enhance the accuracy of ratings and encourage the disclosure of information. In this regard, it argues that the lack of care shown in the CRAs' activities is such as to cause damage to the financial market whenever their 'predictions' are not accurate. Indeed, the CRAs seem to respond more receptively to political concerns and to those of lobbies.¹⁴³

¹⁴¹ John C. Coffee Jr. (note 8) 324-325.

¹⁴² Avinash Persaud, 'The right direction for credit rating agencies' *Financial Times* (London, 18 October 2007).

¹⁴³ Philip Stephens, 'Downgrade the rating agencies' *Financial Times* (London, 20 January 2012).

This research also attempts to demonstrate that there is a need for an independent body with the function of monitoring the accuracy of CRAs' opinions of default events.¹⁴⁴ CRAs usually rate the credit default risk of the assets to which they give a particular rating. This aspect has been misinterpreted because a rating covers market and liquidity risk as well. Regulators could require the financial industry to standardize what ratings mean, instead of every ratings agency having its own particular interpretation of ratings.

In order to address these questions, this research assumes that a structural reform of CRAs' internal governance is required. Thus, the investigation seeks to demonstrate that reform of the CRAs is to be preferred over free market solutions that permit anyone to issue credit ratings and anyone to rely on them.¹⁴⁵ In particular, the research analysis proposes a new accountability approach in which CRAs are subject to closer regulation and a liability regime. Consequently, this research aims to define a regulatory environment in which credit rating agencies can play a useful and efficient role as informational intermediaries.

Additionally, the research provides an analysis of the CRAs' role in financial markets through the study of decided cases. Deeper CRA analysis can be expected to show the nature of the interaction (or cooperation) between rating agencies and issuers. This would ascertain whether these groups cooperate to maximize their joint profits regardless of consumers.

The aim is to provide suggestions for keeping the effectiveness of the CRAs' work and the protection of investors aligned. The ultimate aspiration is that people who pursue profits at the same time benefit the public.

The analysis of the role of CRAs is designed to facilitate understanding of what kind of regulatory tools are needed for CRAs. Once again, incomplete information is the central problem of the rating agencies/investors relationship.

However, another question is to understand how these parties bargain with one another and the way in which they allocate the information. It is important to note that adequate investor protection against market distortions requires trustworthiness and reliability.¹⁴⁶

¹⁴⁴ Charles A.E. Goodhart (note 81) 121.

¹⁴⁵ The analysis intends to extend the point made by Coffee. See John C. Coffee Jr. (note 47) 5-6.

¹⁴⁶ According to the economic literature, market distortions could be determined by phenomena such as moral hazard and adverse selection. Moral hazard occurs in the insurance sector when the behaviour of the insuree changes after the purchase of insurance so that the probability of loss

In order to avoid failures on the part of CRAs, it is necessary that those agencies should perform their role of promoting financial awareness by being accountable for their opinions. This is especially the case as they indeed are more than simple opinion providers.

After explaining the aim and purpose of the research—with particular attention on current problems in the CRAs' sector—the next section illustrates the methodology of the research.

1.8 Methodology of the research

The research methodology concentrates on scholarly opinion and case law. The thesis relies strongly upon US law on the one hand (with numerous references to the securities laws which have been influential for the development of credit rating agencies) and European law on the other hand (with references to the various pieces of legislation that regulates the credit rating sector) as well as specific UK and Australian law. The approach is theoretical and provides a rigorous analysis from the legal perspective of market participants.

In the first part, the focus is on the regulatory framework of CRAs with particular attention being paid to the existing legislation in the US, the UK and the EU. These securities markets designate specific rules that are intended to improve disclosure and set forth a stringent regime for CRAs.

It considers how harmonized rules could eliminate differential treatment under the law and introduce on-going supervision with accountable responsibility for rating agencies. However, methods for securing more cooperation among global regulators, with a system of integrated controls, are also considered. Such methods could require the disclosure of all aspects of the ratings activity, with an emphasis on the evaluation methods and enhancing the transparency of information.

In the second part, an investigation is conducted in terms of the observable differences in the rating agencies' characteristics. A probable development of regulation draws on this investigation.

tends to increase. So 'where one party to a transaction may undertake certain actions that affect the other party's valuation of the transaction but the second party cannot monitor or enforce perfectly'. Vice versa, adverse selection occurs where 'one party to a transaction knows things pertaining to the transaction that are relevant to but unknown by the second party'. See Kreps (note 41) 577.

The evidence emanating from the investigation provides material for further research into aspects such as (1) the motivation of CRAs to issue solicited or unsolicited ratings; (2) the discretion of CRAs to bring into play evaluation models and to control the treatment of information; and (3) the assessment of rating agencies' responsibility. The results are interpreted with regard to the standard of rating activity, evaluating positive and negative effects of adopted regulation. This analysis should provide significant implications with regard to an applicable normative framework.

The original contribution of this research is the design of a regulatory framework to make CRAs accountable while proposing concrete solutions to the problems of information asymmetries and conflicts of interest between issuers and investors. The idea is that CRAs should be made responsible for their investment certification because of their fundamental role in the evaluation of credit risk in influencing investors' confidence.

1.9 Structure of the thesis

Chapter one of the thesis provides an overview of the ratings environment and describes the role of CRAs in the securities markets. The increasing influence of CRAs in the securities sector and their operations—with particular emphasis on certain drawbacks in the current regulatory framework—as well as the longstanding problems associated with the CRAs' activities, is taken into account.

Chapter two focuses on the reliability of CRAs since this has been questioned following the mis-evaluation of the default risk attaching to certain financial products—such as subprime mortgages and derivatives—that adversely affected the stability of securities markets. It is discussed how CRAs' activities have exhibited a lack of due diligence and a deficiency in their assessment of corporations' creditworthiness.

This chapter argues that CRAs exhibit potential conflicts of interest because they have a financial incentive to accommodate the preferences of bond issuers owing to the fact that they are selected and paid for by them. This chapter also focuses on the 'certification role' of CRAs, with particular attention given to criticisms of the ratings market. In this context, account is taken of the function of 'rating triggers' and the major problems regarding their use in financial contracts. The role of rating triggers in financial transactions is examined by considering the

main criticisms of the effects of such clauses on market participants (such as the lack of disclosure of the triggers in contracts). The problem of over-reliance on credit ratings is considered by taking into account the possible presence of ‘unhelpful’ incentives in the CRA industry. The question of free-market interference is discussed in terms of facilitating a systematic dependence on ratings and favouring an artificially high demand for highly rated financial instruments.

Chapter three focuses on the CRAs’ regulatory reforms relating to CRAs that have been adopted in the US, the UK and the EU. It imparts the major concerns associated with the CRAs’ assessment activity. It is contended that government initiatives have restored the transparency and fairness of CRAs by creating a rigorous system of regulation and supervision. However, the success of these regulatory measures is disputed.

It is argued that the legal system set in place by the global regulators¹⁴⁷ namely FSB, G-20, IOSCO and the Basel Committee on Banking Supervision (BCBS) failed to establish an adequate regulatory framework for CRAs.

Chapter four outlines generic grounds of liability such as contract, tort, fiduciary duty, estoppel and statutory right of action. In particular, this chapter focuses on the legal reasoning by which liability might attach to a CRA and identifies the parties who might have a claim and the nature of the damages that might be recovered. The doctrine of ‘equitable estoppel’ is considered as a possible option to hold CRAs liable for inaccurate ratings together with an analysis of the liability scenario under the law of tort.

Chapter five considers the implementation of the generic grounds of liability in the US, the UK, the EU and Australia. This chapter explains why and how each system arrived at its own solution. In this regard, the chapter provides critical reflections of Australian case law, namely the *Bathurst* judgment and, an assessment of the civil liability regime for CRAs established by the EU regulatory framework.

¹⁴⁷ In the international financial architecture, global regulators developed a number of policies, practices, standards, and codes of good practice that can be characterized as soft law. The current activity of the financial markets has permitted the adoption of new methods of regulation characterized by informal rules and sectoral normative instruments. As Lastra argued ‘soft law is informal law. Its main problem is enforcement. Its main drawback is legitimacy. Its greatest advantage is flexibility. Soft law fills a need, a legal vacuum in the regulation of cross-border banking activities. It cannot therefore be dismissed’. See Rosa M. Lastra, *International Financial and Monetary Law* (Oxford: OUP 2015) 554.

Chapter six sets out some concluding remarks and provides a summary of some policy and regulatory recommendations for reform.

The thesis aims to state the law and major policy developments as at 1st August 2014.

Chapter Two

Credit Rating Agencies: Activities and Business Model

2.1 *Background of the credit ratings industry*

This chapter deals with the structure of the CRAs' market. It takes into consideration the business relationship of CRAs and the main concerns arising from it, namely (1) conflicts of interest; (2) inadequate disclosure; (3) limited competition; and (4) lack of transparency.

The role of a CRA is not to measure a security's potential for price appreciation. Rather CRAs collect dispersed information on the financial situation of borrowers and the default risk of certain financial products, and with this information they condense it into a single measure of relative credit risk.¹⁴⁸ In other words, the key function of CRAs is to assess the quality of a company's credit by issuing a rating indicating a liability or the quality of a specific liability issue. CRAs undoubtedly perform a public duty in the financial markets because of the reputational capital they can provide.

The usefulness of a CRA is dependent upon both its reliability in making predictions as well as its public acceptability. These two elements reflect the fact that market participants use the ratings of leading CRAs because they trust their ratings and market participants know that others will also accept their evaluation. It is important that financial markets place trust in the CRAs' activities and the relevant processes that lead up to a rating evaluation. For instance, a low rating can drive up an issuer's borrowing costs or even put it out of business.

CRAs have played a long and established role in financial markets in providing investors with an assessment of the relative probability of default of debt instruments. In this regard, 'credit rating agencies and their output play a unique, indeed important, role in overcoming the information asymmetries that are endemic to the capital market'.¹⁴⁹ This worthy function has changed into a sophisticated and complex technique for measuring financial soundness.

¹⁴⁸ Andreas Kruck, *Private Ratings, Public Regulations. Credit Rating Agencies and Global Financial Governance* (London: Palgrave Macmillan 2011) 1.

¹⁴⁹ Herwig M. Langohr and Patricia T. Langohr, *The Rating Agencies and their Credit Ratings. What They Are, How They Work and Why They Are Relevant* (New York: Wiley & Sons 2008) x.

As indicated in Chapter three, the regulatory background of credit ratings began in the US by approving the use of certain CRAs as a NRSRO. The growth of the credit rating agencies industry took place in the early 1900s when the investment banks started to require evaluations of their issuances and because of the presence of economies of scale associated with spreading credit information. The first CRA was founded by John Moody in 1909 (and was a rating system for railroad bonds) after the establishment of mercantile credit agencies and debt manual publishers. In the early 1900s, Moody's produced manuals of performance statistics related to stocks and bonds. The bond ratings agencies drew their revenue exclusively from subscribers.¹⁵⁰

CRAs developed from market surveillance mechanisms, particularly with the onset of burgeoning volume of financial information. The bond rating services increased in the early 1930s with the Banking Act of 1933 (Glass-Steagall Act)¹⁵¹ and the focus of bond rating activity in the US was railroads, corporations and financial institutions. From these origins, pension funds and banking investments incorporated rating standards into their rules.

In a further development, the SEC and other regulatory institutions enacted normative tools to regulate the rating process. The 'certification' system of ratings introduced by the NRSRO granted to the leading CRAs the benefit of the 'issuer-pays' business model. The latter compensation model replaced the 'investor-paid' scheme (based on subscription fees from investors to rate third parties) which exhibited some shortcomings owing to free-rider problems (for example, the printed ratings manuals were easily copied by non-subscribers with the development of photocopying machines).¹⁵²

Indeed, with the 'issuer-pays' model, CRAs solved the 'free-rider question' of the supply of a public good in the investors' community by way of the public availability of ratings manuals. This rating system was based on subscription fees paid by investors. The symbols of the main CRAs were synthesised in letters, numbers and positive and negative symbols. The letter 'A' signified the highest

¹⁵⁰ Richard Cantor and Frank Packer, 'Multiple ratings and credit standards: differences of opinion in the credit rating industry' (1996) Reserve Bank of New York Staff Report No 12, 3-4. See also Claire A. Hill, 'Regulating the Rating Agencies' (2004) 82 *Washington University Law Quarterly* 1, 47-48; Robert C. Riehle, 'Moody's Municipal Ratings' (1968) 24 *Financial Analysts Journal* 3, 71.

¹⁵¹ Banking Act of 1933 (Pub.L. 73-66, 48 Stat. 162, enacted June 16, 1933).

¹⁵² House of Lords, Select Committee on Economic Affairs, 'Banking Supervision and Regulation', 2nd Report of Session 2008-09 (June 2009) 40, para. 155.

grade, all the way down to the letter ‘D’ signifying the lowest grade (see ‘Appendix I’). The higher the rating, according to the agency, the less is the risk of default on repayment to the creditor. Investors use ratings to reduce the risks of credit loss. Once issued, CRAs maintain scrutiny over issuers and their securities and investors are informed through the rating assessment when changes affect issuers and financial products.

Each CRA depends for its livelihood on its credibility for independence and accuracy. In particular, CRAs operate through their valuable ‘opinions’, thereby making public the information on the credit risks of borrowers. Nonetheless, opinions have varying effects in the same way that ‘the impact of a self-proclaimed messiah on a soap-box at Speaker’s Corner may differ from the impact of a newspaper that prejudices a suspect as being guilty in a murder case’.¹⁵³

Investors rely on ratings evaluations about the likelihood of receiving timely payments on bonds. The rating certification of a bond quality has developed into a pre-requisite of the debt issue’s credit value. CRAs capitalise on their reputational capital, thereby obtaining huge market power over investors, while exploiting the information asymmetry between issuers and investors.

However, there is a link between the certification activity and the signalling purpose of ratings. As Partnoy noted, ‘CRAs exist in a competitive market of information providers and live or die based on their reputational capital’.¹⁵⁴

The ‘reputational capital’ view considers that credit ratings are important parts of credit information and therefore constitute sound proxies for changes in the credit quality of the underlying bond. CRAs increased their degree of trustworthiness by publishing rating manuals and analysis.¹⁵⁵

Reputational capital, built up by the expertise and authority an agency possesses, can and often does, trump certain examples of poor or misjudged assessments. Sinclair argued that ‘market and government actors take account of rating agencies, not because the agencies are right but because they are thought to

¹⁵³ Andrew Fight, *The Ratings Game* (New York: Wiley & Sons Ltd. 2001) 3.

¹⁵⁴ Frank Partnoy, ‘The Siskel and Ebert of Financial Markets?’ Two Thumbs Down for the Credit Rating Agencies’ (1999) 77 *Washington University Law Quarterly* 3, 635.

¹⁵⁵ See the volume *Analysis of Railroad Investments* published by Moody in 1909.

be an authoritative source of judgements, thereby making the agencies key organizations controlling access to capital markets'.¹⁵⁶

Although the reputational capital theory explains why CRAs have enormously increased their profile and power over recent decades, it does not explain why regulators and investors have become so reliant on ratings when financial markets have evolved into a complex structure involving the usage of high leverage and structured finance. As Partnoy observed, the inconsistency of the reputational capital view may be explained by three concerns: (1) inaccuracies in credit spread estimation; (2) increases in ratings-driven transactions; and (3) the growth of credit derivatives.¹⁵⁷

In a similar vein, 'the reputational capital view is contradicted by the notion that there were systematic inefficiencies in the non-investment-grade bond market allowing the owner of a diversified portfolio of corporate high-yield bonds to outperform, on a risk-adjusted basis, other fixed income investments'.¹⁵⁸ The exponential rise of CRAs in the 1900s could be explained by the development of structured finance, the spread of complex financial instruments (such as credit derivatives¹⁵⁹, asset-backed securities¹⁶⁰, financial guarantees¹⁶¹, arbitrage vehicles¹⁶² and others).

Generally, CRAs have strong reasons to avoid inaccuracy because of the potential effect on their reputational capital. A central feature in the current rating

¹⁵⁶ Timothy J. Sinclair, *The New Masters of Capital. American Bond Rating Agencies and the Politics of Creditworthiness* (Ithaca, NY: Cornell University Press 2005) 2. In particular, the author argues that 'rating agencies, acting as embedded knowledge networks, can be thought to adjust the "ground rules" inside international capital markets, thereby shaping the internal organization and behaviour of institutions seeking funds' (at 15).

¹⁵⁷ Frank Partnoy (note 154) 654.

¹⁵⁸ *ibid* 663.

¹⁵⁹ A credit derivative is an agreement designed explicitly to shift credit risk between the parties. Its value is derived from the credit performance of one or more corporations, sovereign entities, or debt obligations. See David Mingle, 'Credit Derivatives: An Overview' (2007) 92 *Economic Review* 4, 1.

¹⁶⁰ An asset backed security is a bond which is backed by the cash flows from a pool of specified assets in a special purpose vehicle rather than the general credit of a corporation. See Gary B. Gorton and Andrew Metrick, 'Haircuts' (2009) National Bureau of Economic Research Working Paper 15273, 12 <<http://www.nber.org/papers/w15273>> accessed 10 June 2013.

¹⁶¹ Financial guarantees can be defined as insurance policies that oblige the guarantor to make the promised payment on a financial contract if the issuer fails to do so. See Robert C. Merton and Zvi Bodie, 'On the Management of Financial Guarantees' (1992) 21 *Financial Management* 4, 90.

¹⁶² Arbitrage vehicles such as credit arbitrage vehicles (Structured Investment Vehicles) are companies which seek to 'arbitrage' credit by issuing debt or debt-like liabilities and purchasing debt or debt-like assets, and earning the credit spread differential between its assets and liabilities. See Frank Partnoy, 'Overdependence on Credit Ratings was a Primary Cause of the Crisis' (2009) University of San Diego, Legal Studies Research Paper Series No 09-015, 5-6.

system is regulators' over-reliance on wide market acceptance of a rating assessment. CRAs can influence, through 'downgrades', the capacity of borrowers to obtain funds. In this regard, the most important factor is the limited competition among CRAs. This factor allows for the accumulation of reputational capital and the imposition of market power over investors. If the information sold does not reflect the credit spreads, CRAs sell other values such as the right to reduce regulatory costs or the right to obtain the benefits of entering in the securities market with a valuable rating.

The credit spread represents the market's estimate of the riskiness of the bond compared to its risk-free counterpart, based on both the probability of default and the expected recovery in the event of default. Put in another way, the credit spread is the difference between the yield on the bond and the yield on a risk-free bond of comparable structure and maturity. It also represents one of the most important measures of credit risk.¹⁶³ The credit spread is a reflection of all available information in the market, including the rating.

The credit rating should reflect the estimation of credit spread, but the evidence does not always support the conclusion that ratings reflect valuable and accurate information.¹⁶⁴ Therefore, announcements signalling a rating change provide no new information to the capital markets.¹⁶⁵

Regulatory protection confers credibility and reputational capital on CRAs. This allows for the circumventing of rules and supervision because of regulatory permission to incorporate the rights of providing valuable certification. Such protection has reduced the incentive to maintain quality ratings.

There are plenty of reasons to believe that CRAs' activity has been changed by the regulators as result of regulatory activity. Global regulators have altered the nature of the CRAs' core business from that of 'informational intermediary' to that of a 'regulatory intermediary'. Issuers have started to pay rating fees, not only to purchase credibility with the investor, but also, and in particular, to purchase a 'license' from the regulators.

¹⁶³ Another measure of credit risk is the Option Adjusted Spread (OAS), in which is accounted the riskiness of a bond compared to its risk-free counterpart.

¹⁶⁴ In recent years, several cases of corporate default have demonstrated the inaccuracy of credit ratings: for instance, the well-known cases of Lehman Brothers, WorldCom and Enron in the early 2000s.

¹⁶⁵ Lee Macdonald Wakeman, 'The real function of Bond Rating Agencies' in Clifford W. Smith Jr. (ed), *The Modern Theory of Corporate Finance* (2nd edn, New York: McGraw-Hill 1990) 411.

It can be argued that credit ratings act as an instrument for regulatory purposes. This argument is evidenced by the fact that CRAs are so powerful, despite their failure to always supply valuable and accurate information. The ratings authority is underlined by daily statements of issuers' creditworthiness, followed by an investment grade assessment. Owing to the status granted by government legislation and global regulators, CRAs act as profitable arbiters of the financial markets. In sum, the development of credit ratings shows that 'the important point is not what rating you have, but whether or not you have a rating'.¹⁶⁶ In other words, issuers utilise the rating 'as a mirror for larks' to attract investors and market participants.

After providing a brief overview of the background of credit ratings industry, the next section considers the 'gatekeeper function' of CRAs taking into account the characteristics of ratings services and their relevance in the securities market.

2.2 *The 'gatekeeper' function: solicited and unsolicited ratings*

The increasing role of the ratings industry in the financial sector has attracted much attention, particularly on account of the private and public purposes of CRAs. The involvement of ratings in global institutions underlines the fact that 'the use of raters' activities by national and international regulatory bodies constitutes a form of delegation of governance tasks and (quasi-) regulatory authority from public to private actors'.¹⁶⁷

Ratings can be assigned under a quantitative (based on quantitative information only) or a qualitative approach (characterised by a process of human expert analysis). Usually, CRAs set their ratings on the basis of both quantitative and qualitative assessments of the borrowing issuer's condition.

In the case of solicited ratings, ratings are directly requested and paid for by the issuer of the rated product. This system is based on the close issuer-credit rating relationship because of confidential participation by the issuer in the ratings process. CRAs have recourse to non-public information to assess a financial product.¹⁶⁸

¹⁶⁶ *ibid* 410.

¹⁶⁷ Andreas Kruck (note 148) 5.

¹⁶⁸ Non-public information can include credit agreements, acquisition agreements, private placement memoranda, and business projections and forecasts.

Non-public information is often provided pursuant to a confidentiality agreement between the CRA and the issuer, or is provided premised upon the rating agency's policy to keep such information confidential.¹⁶⁹ However, in this type of rating services authors contend that there is a deep and persistent conflict of interests between issuers and raters which results in information asymmetries to the disbenefit of investors.¹⁷⁰

Solicited ratings characterise the 'issuer-pays' business model in which CRAs are directly paid by their principals, e.g. companies, investment banks, etc. Within this model, potential conflicts of interest arise because of possible collusive actions in the agencies' relationship. Since the rating fee is paid by the principal, the issuer may be able to influence the rating obtained by threatening to use another agency or none at all if the rating assigned by the agency is deemed by the principal to be too low.¹⁷¹

In conducting their analysis, CRAs may obtain information from issuers that might not otherwise be available to the public and factor this information into their ratings opinion. In this business model, managers and raters are often involved in the ratings process and participate, inevitably, in discussions concerning the fees to be paid for the rating services. Such a model has the potential for conflicts of interest since the entities are paying for the rating.

Solicited ratings are subject to other concerns too. One is referred to as 'shopping for raters', which is the practice of issuers choosing the best ratings from among a set of possible rating agencies and the quality of the disclosed information. These concerns are related to the strategic behaviour between principal and agent. In cases of 'rating shopping', issuers move from one rating agency to another until they receive a favourable rating.¹⁷² It has been claimed

¹⁶⁹ SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets. As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002' (January 2003) 26.

¹⁷⁰ Timothy E. Lynch, 'Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment' (2009) 59 *Case Western Law Review* 2, 246-247.

¹⁷¹ George G. Kaufman, 'The financial turmoil of 2007-20XX: causes, culprits and consequences' in John Raymond Labrosse, Rodrigo Olivares-Caminal and Dalvinder Singh (eds), *Financial Crisis Management and Bank Resolution* (London: Informa London 2009) 4.

¹⁷² Tracy Alloway and Christopher Thompson, 'Doubts raised over rating agency reform' *Financial Times* (London, 11 June 2014). Rating shopping is defined as 'the pre-crisis practice where issuers would sound out rating agencies for their initial feedback on a deal, and then hire the agency that offered the best possible designation'.

that ‘rating agencies that give out lower ratings risk their ratings not being selected and thus losing revenue to their less honest peers’.¹⁷³

The largest multinational companies have the capacity to shop for the highest ratings on their lucrative issuance deals, including playing one CRA against another when informally consulting them on structures to achieve high ratings.¹⁷⁴ The upshot is a lack of competition, huge barriers for new entrants, higher conflicts of interest and low transparency. In the case of a new CRA, a single fee-paying issuer may constitute a large portion of the CRA’s overall revenue, thereby creating a potential conflict of interest that may influence its rating decisions should the new entrant fear a loss of this business.¹⁷⁵ One can argue that the ratings business model can affect CRAs’ reputational capital because of the dubious relationship between raters and issuers: this potential for collusive behaviour may influence the ratings process through biased assessment.

The second service, unsolicited ratings, i.e. ratings that credit rating agencies conduct without being formally engaged to do so by the issuer, is based on public-rated activity. In this case, CRAs are not paid by the issuer and conduct their assessments using publicly available information about the financial product. In the words of S&P’s, ‘unsolicited ratings are those credit ratings assigned at the initiative of S&P’s and not at the request of the issuer or its agents’.¹⁷⁶

Public information reviewed in the ratings process typically includes filings such as news reports, industry reports, bond and stock price trends and data from central banks. This type of rating is the subject of some controversy in the associated literature¹⁷⁷, although it seems clear that unsolicited ratings influence the markets and do at least reflect the level of public disclosure of the firms rated. The major questions regard the opacity of the rating process behind an unsolicited rating (in the absence of issuer input) and unclear access to public information.

¹⁷³ Lynn Bai, ‘On regulating conflicts of interest in the credit rating industry’ (2010) 13 *Journal of Legislation and Public Policy* 2, 263.

¹⁷⁴ Nicolette Kost de Sevres and Lorenzo Sasso, ‘The new European financial markets legal framework: a real improvement? An analysis of financial law and governance in European capital markets from a micro- and macro-economic perspective’ (2012) 7 *Capital Markets Law Journal* 1, 50.

¹⁷⁵ IOSCO Technical Committee, ‘Report on the activities of credit rating agencies’ (September 2003) 14.

¹⁷⁶ S&P’s, ‘Standard & Poor’s Ratings Definitions’ (24 February 2012) <<http://www.standardandpoors.com/ratings/articles/en/eu/?articleType=HTML&assetID=1245329361492>> accessed 28 February 2012.

¹⁷⁷ Soku Byoun and Yoon S. Shin, ‘Unsolicited Credit Ratings: Theory and Empirical Analysis’ (2002) Working Paper, Financial Management Association Annual Meeting, 3-5.

CRA's may issue unsolicited ratings in order to force issuers to pay for ratings that they did not request.¹⁷⁸ Further, unsolicited ratings are used as a way of establishing a track record before breaking into a new market.¹⁷⁹

Unsolicited ratings have been described as simplistic and opportunistic. In particular, 'rating agencies have been accused of running an operation akin to a classic protection racket in summarily issuing unsolicited ratings to various entities that are perceived as vulnerable to paying rating fees'.¹⁸⁰

Empirical evidence has shown that unsolicited ratings tend to be lower than solicited ratings because of self-selection among issuers and the strategic conservatism of rating agencies.¹⁸¹

Specifically, when issuing unsolicited ratings, CRA's tend to assign lower ratings than when hired and paid to do so. This may happen because there is no direct cooperation between issuers and raters and because of the incomplete and low quality of information available to the CRA's. Although some empirical studies have shown that unsolicited ratings tend to be lower than solicited ratings¹⁸², the assumption that lower unsolicited ratings relative to solicited ratings reflects the bias of unsolicited ratings is still debatable.¹⁸³

In contrast, some commentators argue that unsolicited ratings provide a powerful check against rating shopping and can affect the yield paid at issuance.¹⁸⁴ Other scholars observe that unsolicited ratings are characterised by a downward trend in contrast to solicited ratings. This difference in ratings comes from the significant self-selection bias (unsolicited ratings are still lower than

¹⁷⁸ Lynn Bai (note 173) 264. The author observes that this happened in the leading case of *Jefferson County School Dist. No. R-1 v Moody's Investor's Services, Inc.* [1999], No 97-1157.

¹⁷⁹ *ibid* 264-265.

¹⁸⁰ Andrew Fight (note 153) 2.

¹⁸¹ Christina E. Bannier, Patrick Behr and Andre Güttler, 'Rating Opaque Borrowers: Why Are Unsolicited Ratings Lower?' (2010) 14 *Review of Finance* 2, 263-266. The authors suggest that 'lower unsolicited ratings could simply be caused by a self-selection of high quality companies into the solicited rating status and of low-quality firms into the unsolicited (or no) rating status'.

¹⁸² Soku Byoun and Yoon S. Shin, 'Information content of unsolicited credit ratings: evidence from Japanese firms' (2012) 41 *Asia-Pacific Journal of Financial Studies* 1, 59; Christina E. Bannier, Patrick Behr and Andre Güttler, 'Rating Opaque Borrowers: Why Are Unsolicited Ratings Lower?' (2010) 14 *Review of Finance*, 263.

¹⁸³ Soku Byoun, Jon A. Fulkerson, Seung Hun Han and Yoon S. Shin, 'Are unsolicited ratings biased? Evidence from long-run stock performance' (2014) 42 *Journal of Banking and Finance*, 326-327.

¹⁸⁴ Richard Cantor and Frank Packer, 'The Credit Rating Industry' (1994) 19 *Federal Reserve Bank of New York Quarterly Review* 2, 5.

solicited ratings after controlling differences in sovereign risk and key financial characteristics).¹⁸⁵

In this context, instructive research has demonstrated that public disclosure not only appears to have a positive effect on credit ratings, but it also seems to eliminate the downward bias of unsolicited ratings.¹⁸⁶ Such research considers that unsolicited ratings are lower so as to ‘punish’ issuers who otherwise would not purchase ratings coverage or that unsolicited ratings are lower because they are based only on public information and, as argued in academic circles, tend to be more conservative than solicited ratings.¹⁸⁷ Further empirical studies find that there is a significant difference in the distributions of ratings because banks that have received shadow ratings are smaller and have weaker financial profiles than banks that have other ratings.¹⁸⁸

A further area for analysis is whether unsolicited ratings are used to increase the market share and extract payment from an unwilling issuer. CRAs tend to force companies to purchase their services with the purpose of making a profit. In addition, ‘an unsolicited rating is “feared” because it might put an issuer’s credit risk in a worse light than it actually is with the justification that it only reflects publicly available information’.¹⁸⁹

By making unsolicited ratings, CRAs operate as an unfair and anticompetitive market participant because of speculative actions and abusive practices.¹⁹⁰ Unsolicited ratings may discourage new entrants from trying to build up a niche position because CRAs have traditionally been able to take advantage of economies of scale in ways that may inhibit entry for smaller competitors.¹⁹¹

The 2004 IOSCO Code of Conduct stated that ‘for each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating

¹⁸⁵ Winnie P.H. Poon, ‘Are unsolicited credit ratings biased downward?’ (2003) 27 *Journal of Banking & Finance* 4, 613.

¹⁸⁶ Patrick Van Roy, ‘Is there a difference between solicited and unsolicited bank ratings and if so, why?’ (2006) National Bank of Belgium, *Working Papers Research Series* <<http://www.nbb.be>> accessed 29 February 2012, 25.

¹⁸⁷ *ibid* 2.

¹⁸⁸ Winnie P.H. Poon and Michael Firth, ‘Are Unsolicited Credit Ratings Lower? International Evidence From Bank Ratings’ (2005) 32 *Journal of Business Finance & Accounting* 9-10, 1768.

¹⁸⁹ Fabian Dittrich, ‘The Credit Rating Industry: Competition and Regulation’ (2007) <<http://ssrn.com/abstract=991821>> accessed 28 February 2012, 110.

¹⁹⁰ Elisabetta Cervone, ‘Regulating Credit Rating Agencies in a Transatlantic Dialogue’ (2008) 19 *European Business Law Review* 5, 838.

¹⁹¹ Pragyam Deb, Mark Manning, Gareth Murphy, Adrian Penalver and Aron Toth, ‘Whither the credit ratings industry?’ Bank of England, Financial Stability Paper No 9, March 2011, 7.

not initiated at the request of the issuer should be clearly identified as such. The IOSCO Code also held that the CRA should also disclose its policies and procedures regarding unsolicited ratings'.¹⁹²

The 2011 IOSCO Report affirmed in its "CRA Principle Transparency and timeliness of ratings disclosure" that 'CRAs should make disclosure and transparency an objective of their ratings activities'.¹⁹³ This principle intends to promote the distribution of sufficient information regarding ratings procedures and methodologies because there is risk of investor confusion in the issuance of unsolicited ratings.

Consumer confusion arises when ratings do not merely represent additional valuable information about the financial products but lead to investor uncertainty and force companies to purchase their services.¹⁹⁴

The consequences of unsolicited ratings are important because of the increasing market share and low accuracy. At the European level, the Commission recommended that disclosure requirements for solicited and unsolicited ratings should be strengthened by requiring CRAs to inform issuers for which they are in the process of issuing a rating sufficiently in advance of the publication of the rating.¹⁹⁵ It also included a requirement to elaborate on the main assumptions which justify the change of rating.

In conclusion, the significant increase over time of references to credit ratings in rules and regulations—combined with scarce competition—has affected the

¹⁹² IOSCO Technical Committee, 'Code of Conduct Fundamentals for Credit Rating Agencies' (December 2004) 9.

¹⁹³ IOSCO Technical Committee, 'Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies. Final Report' (February 2011) 30-31.

¹⁹⁴ Francis A. Bottini Jr, 'An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies' (1993) 30 *San Diego Law Review* 3, 600.

¹⁹⁵ European Commission, Proposal for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies and a Proposal for a Directive amending Directive 2009/65/EC on coordination on laws, regulations and administrative provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers (15 November 2011) Commission Staff Working Paper, 180 (OJ 2011, L 174, p. 1).

See also Regulation No 446/2012 of 21 March 2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards on the content and format of ratings data periodic reporting to be submitted to the European Securities and Markets Authority by credit rating agencies (OJ 2012, L 140, p. 2) and Regulation No 448/2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards for the presentation of the information that credit rating agencies shall make available in a central repository established by the European Securities and Markets Authority (OJ 2012, L 140, p. 17).

business model of CRAs by creating a more or less ‘guaranteed market’ with few incentives to compete on the basis of rating quality.¹⁹⁶

After providing a critical appraisal of the ratings services, the following section examines the rating methodologies taking into account the controversial aspects of ratings criteria.

2.3 *The rating methodologies*

It is generally considered that rating methodology refers to the methods and processes that govern CRAs’ application of criteria to a particular rating or practice (e.g. corporate, public finance, asset-backed securities).¹⁹⁷ Rating methodology is designed to measure the creditworthiness (or likelihood of default) of an issuer or an obligation. But beyond the likelihood of default other important factors are: (1) the payment priority of an obligation following default; (2) the projected recovery that an investor would expect to receive if an obligation defaults; and (3) credit stability.

Rating systems represent a validation process consisting of a formal set of activities, instruments and procedures aimed at ensuring that the design of a model is conceptually sound.¹⁹⁸ Therefore, a credit rating is the result of a credit rating process. A credit rating process involves a subjective assessment of both the qualitative and quantitative factors of a financial instrument. This process begins with an application by the issuer to the rating agencies.

CRAs are dependent on ratings criteria, analyst and committee views, and surveillance processes, which can vary over time and across ratings systems. S&P’s has affirmed that ‘creditworthiness is complex and while there is no formula for combining the different factors into an overall assessment, the criteria provide a guide in considering these factors’.¹⁹⁹ The key objective is rank ordering the relative creditworthiness of issuers and obligations.

¹⁹⁶ John Kiff, Allison Holland, Michael Kisser, Sylwia Nowak, Samer Saab, Liliana Schumacher, Han van der Hoorn and Ann-Margret Westin, ‘The Uses and Abuses of Sovereign Credit Ratings’, in IMF World Economic and Financial Surveys. Global Financial Stability Report. Sovereigns, Funding and Systemic Liquidity (October 2010) 94.

¹⁹⁷ S&P’s, ‘Guide to Credit Ratings Criteria. Why criteria are important and how they are applied’ (2010) <www.standardandpoors.com> accessed 1 March 2012, 3.

¹⁹⁸ Luisa Izzi, Gianluca Oricchio and Laura Vitale, *Basel III Credit Rating Systems. An Applied Guide to Quantitative and Qualitative Models* (London: Palgrave Macmillan 2012) 114.

¹⁹⁹ S&P’s, ‘Understanding Standard & Poor’s Rating Definitions’ (2010), <www.standardandpoors.com/ratingsdirect> accessed 5 March 2012, 6.

When assigning and monitoring ratings, CRAs consider whether they believe an issuer or security has a high likelihood of experiencing unusually large, adverse changes in credit quality under conditions of moderate stress.²⁰⁰

Rating methodologies are detailed processes for applying criteria to develop a rating. An example would be the specific quantitative measures that CRAs use to assess current and future cash flows and the ability to cover expected interest expense for issuers in specific industry sectors.²⁰¹ For instance, the sovereign rating methodology addresses the factors that affect a sovereign government's willingness and ability to service its debt on time and in full. CRAs determine sovereign ratings based on a range of quantitative and qualitative factors by which they gauge a country's ability and willingness to repay its debt.²⁰²

There are three types of credit rating 'scales': (1) the fundamental ordinal scale which is used by CRAs to position the creditworthiness of an issuer or instrument; (2) financial market credit spreads, which result from the investment decisions of bond investors; and (3) market-implied credit ratings, which are derived from a combination of mathematical modelling of the arbitrage equilibrium prices of an issuer's equity and assets, probability theories and empirical observations of past defaults.²⁰³

The CRA's criteria are a significant part of the rating outcome because they identify the specific factors that agencies consider during the rating and surveillance processes. Rating criteria reports describe the methodology used in assigning ratings.²⁰⁴ According to Fitch, the criteria and methodology used to determine a rating action are those in effect at the time the rating action is taken, which is the date of the related rating action commentary.²⁰⁵

Rating methodologies and criteria can be subjected to some form of objective validation based on historical experience. CRAs' methodologies regard country-specific risks, industry and economic data, historical and projected financial

²⁰⁰ S&P's, 'Methodology: Credit Stability Criteria' (2011), <www.standardandpoors.com/ratingsdirect> accessed 5 March 2012, 2.

²⁰¹ S&P's (note 206) 3.

²⁰² Ashok Vir Bhatia, 'Sovereign Credit Ratings Methodology: An Evaluation' (2002) IMF Working Paper No 02/170, 4-6.

²⁰³ Herwig M. Langohr and Patricia T. Langohr (note 156) 43.

²⁰⁴ Fitch Ratings, 'Managing and Developing Criteria and Models' (30 September 2011) <www.fitchratings.com> accessed 1 March 2012, 1.

²⁰⁵ Fitch Ratings, 'Code of Conduct' (22 November 2011) <www.fitchratings.com> accessed 1 March 2012, 11-12.

statements, the history of defaults, management policies, and the features of the specific financial product.

In forming their opinions of credit risk, CRAs primarily use analysts or mathematical models, or a combination of the two. S&P's claims that in the case of 'model driven ratings' a small number of credit rating agencies focus almost exclusively on quantitative data, which they incorporate into a mathematical model.²⁰⁶ An agency using this approach to assess the creditworthiness of a bank or another financial institution might evaluate that entity's asset quality, funding, and profitability based primarily on data from the institution's public financial statements and regulatory filings.

Credit ratings express risk in relative rank order, which is to say they are ordinal measures of credit risk and are not predictive of a specific frequency of default or loss. Elaborating credit analysis, CRAs use the terms 'investment grade' and 'speculative grade' to describe the categories. 'AAA' to 'BBB' is considered investment grade and 'BB' to 'D' is considered speculative grade (see 'Appendix I').

In the words of S&P's, the term 'investment grade' historically referred to bonds and other debt securities that bank regulators and market participants viewed as suitable investments for financial institutions.²⁰⁷ The term is broadly used to describe issuers and issues with relatively high levels of creditworthiness and credit quality. In addition, the term 'non-investment grade' or 'speculative grade' generally refers to debt securities where the issuer currently has the ability to repay but faces significant uncertainties, such as adverse business or financial circumstances that could affect credit risk. As such, the terms 'investment grade' and 'speculative grade' are used as market conventions. Investment grade categories indicate a relatively low to moderate credit risk, while ratings in the 'speculative' categories either signal a higher level of credit risk or, indeed, that a default has already occurred.²⁰⁸

²⁰⁶ Standard & Poor's, 'Guide to Credit Rating Essentials. What are credit ratings and how do they work?' (2011) <www.standardandpoors.com> accessed 1 March 2012, 7.

²⁰⁷ *ibid* 11.

²⁰⁸ Fitch, 'Definitions of Ratings and Other Forms of Opinion' (December 2011), <www.fitchratings.com> accessed 6 March 2012, 186.

As discussed earlier, rating methodology represents an important part of the rating process because of its impact on the credit quality of financial products (the cost of issuing debt).

The rating process often incorporates information about background data, forecasts, risk reports, or factual feedback on proposed analytical research and other communications. At the start of the rating process, each rated entity or transaction is assigned to a primary analyst who works with the support of a secondary analyst. Ratings are formulated and reviewed using a committee process. Primary analysts incorporate the information from their research into their rating recommendation and supporting committee package.²⁰⁹ Key analytical factors are discussed in the rating report, while the credit analyst provides a recommendation for a credit rating to a rating committee.

Rating decisions are based on a simple majority vote by the committee and represent the CRA's opinion as to the likelihood that the issuer will honour its financial obligations. By voting, the committee assigns the rating, for which it takes collective responsibility.²¹⁰ The rating process is characterised by rating outlooks that indicate the potential direction of a rating over the intermediate term and rating reviews that give a stronger indication of future rate changes.²¹¹

In the case of collateralised debt obligations ratings, assets rated by the rating agency are counted at face value, while assets rated by a different rating agency are typically graded downwards. Continuous and active surveillance is provided by rating analysts in order to ensure that rated notes are performing within the initial parameters and assumptions.²¹²

It is reasonable to describe a credit rating as an overall financial statement in the form of an opinion delivered at the end of an internal process conducted by rating analysts and highly skilled professionals. However, no formal training or educational certificate, legal background, or degree qualification is required in order to work as a rating analyst. Nonetheless, their statements have legal implications for the financial markets as a whole. As Fight observed, 'rating analysts do not have any formal qualifications, they do not sign off on statements,

²⁰⁹ Fitch Ratings, 'The Ratings Process', Special Report (2 December 2011) 3.

²¹⁰ Herwig M. Langohr and Patricia T. Langohr (note 156) 170.

²¹¹ *ibid* 176-177.

²¹² John M. Griffin and Dragon Yongjun Tang, 'Did Credit Rating Agencies Make Unbiased Assumptions on CDOs?' (2011) 101 *American Economic Review* 3, 126.

and they do not have a legal responsibility to stand behind the opinions they proffer'.²¹³

The different methods and approaches of rating raise questions about the underlying independence of rating agencies and the objectivity of rating assessment. CRAs refer to financial statements, information about the issuer, industry and market level factors. However, the exact factors and related weights of these factors utilised in determining a credit rating are not publicly disclosed by the rating agencies.

CRAs contact the issuer's management before starting the analysis of financial products. The involvement of the issuer in the rating analysis, particularly in the agency's meeting, could result in potentially collusive behaviour between the issuer and the rating committee. Internal ratings are based on economic and mathematical models that provide a score or rating range and this is used to determine the final internal rating as decided by a committee of experts.²¹⁴

Overriding the mathematical rating is subject to written internal rules and policies to ensure the objectivity of the internal rating. The difficulty is, however, how to determine the accuracy of these models because of the subjectivity of the credit rating process. The lifetime of a rating, terminology and qualifiers represent an important part of the rating process because they provide additional information about the specific meaning of the rating.

In terms of a rating's lifetime, a rating is called 'new' when it is assigned for the first time to an issuer. Then, the rating is reviewed on a regular basis and is downgraded or upgraded when it has been lowered or raised in the scale. A rating can be removed for any reason that involves the credit agency and it can be stopped when the issue is paid in full, when the issue reaches maturity and when the issue is called 'early' or 'refinanced'.²¹⁵

Rating methodologies use the terms 'point-in-time' and 'through-the-cycle'. More precisely, 'point-in-time' systems attempt to produce ratings that are responsive to changes in current business conditions while 'through-the-cycle'

²¹³ Andrew Fight (note 153) 4.

²¹⁴ Tony Van Gestel and Bart Baesens, *Credit Risk Management* (Oxford: OUP 2009) 117-118.

²¹⁵ *ibid* 118-119.

systems attempt to produce ordinal rankings of obligors that tend not to change over the business cycle.²¹⁶

A ‘point-in-time’ rating system uses all currently available obligor-specific and aggregate information to assign obligors to risk brackets. For its part, a ‘through-the-cycle’ rating system uses static and dynamic obligor characteristics but tends not to adjust ratings in response to changes in macroeconomic conditions. It should be noted that CRAs have recently started to develop new methodologies that shift the criteria from a ‘through-the-cycle’ to a ‘through-a-crisis’ focus.²¹⁷

A range of substantial studies have shown that ‘analysis of a stylised model of rating systems indicates that the default probability assigned to each obligor rating grade and its dynamics strongly depends on the type of rating methodology and quantification techniques employed’.²¹⁸ Other commentators have attempted to demonstrate the validity of the different measures of structured finance ratings performance, namely ‘default or impairment studies’ and ‘ratings transition analysis’.²¹⁹

For CRAs, the key element in credit risk models is the measure of the ‘probability of default’, but exposure is also determined by the expected timing of default and by the ‘recovery rate’ after default has occurred.²²⁰ The myriad of ways in which ratings drive investment decisions and collateral eligibility standards have attracted the attention of regulators, particularly in the wake of the recent financial crisis. In terms of rating methodology, CRAs claim that they do not target their ratings to specific credit risk metrics, such as default probabilities or expected losses, but only to ordinal rankings of credit risk.

Rating methodologies evolve over time and continue to be adjusted in response to new information and economic developments.

²¹⁶ Basel Committee on Banking Supervision, ‘Studies on the Validation of Internal Rating Systems’ (2005) Working Papers No 14, 14.

²¹⁷ In comparison with the ‘through-the-cycle’ rating approach, this new stability criterion allows for hypothetical scenarios affecting fundamental components. In this way, ratings become measures of risk conditional on the realization of extreme scenarios. See John Kiff, Allison Holland, Michael Kissler, Sylwia Nowak, Samer Saab, Liliana Schumacher, Han van der Hoorn and Ann-Margret Westin (note 196) 91.

²¹⁸ Basel Committee on Banking Supervision (note 216) 2.

²¹⁹ Martin Hansen and Ebru Demir, ‘Are Credit Enhancements Risk-Sensitive? A New Technique for Evaluating Structured Finance Ratings Performance’ (2010) 15 *The Journal of Structured Finance* 4, 58.

²²⁰ Marwan Elkhoury, ‘Credit Rating Agencies and their potential impact on developing countries’ (2008) UNCTAD, Discussion Papers No 186, 4.

At EU level, Regulation (EU) No 462/2013 attempts to ensure that ‘modifications to the rating methodologies do not result in less rigorous methodologies’.²²¹ Article 8(2) of the 2013 CRA Regulation aims to overcome the opacity in the management and operation of CRAs by requiring that ‘the credit ratings and the rating outlooks it issues are based on a thorough analysis of all the information that is available to it and that is relevant to its analysis according to the applicable rating methodologies’.²²² It is important that rating activities ensure ongoing transparency, disclosure of information, monitoring and fairness of their methodologies. The quality of the rating process should be oriented to the investor perspective.

After providing an overview of the ratings methodologies and ratings process, the next section analyses the discipline of conflicts of interest taking into account the major concerns of the business models of CRAs.

²²¹ Recital 27 in the preamble to Regulation (EU) No 462/2013.

²²² Article 8(2) of Regulation (EU) No 462/2013.

Diagram 1: The Credit Ratings Process



Source: Compiled by the author using data from Fitch Ratings, 'The Ratings Process', Special Report (2 December 2011) 8; S&P's, 'Guide to Credit Rating Essentials. What are credit ratings and how do they work?' (2011) 8; and, 'Guide to Credit Ratings Criteria. Why criteria are important and how they are applied' (2010) 11.

2.4 Conflicts of interest

One of the most important aspects of the governance of CRAs is how conflicts of interest are regulated. It is inevitable that the 'issuer-pays' business model raises the possibility that an issuer may use, or the credit rating agency may

perceive, monetary pressure to improve the rating.²²³

Nonetheless, CRAs exhibit potential conflicts of interest because they have a financial incentive to accommodate the preferences of bond issuers owing to the fact that they are selected and paid by the issuers.²²⁴ This heavy dependence is bound to result in both ratings inflation and inaccuracy. In fact, issuers place a higher premium on rather than on accurate ratings.²²⁵

The higher the securities rating, the less concern investors will have about payment default, the greater the liquidity and the lower the issuers' cost of capital. As a result, any investor who relies to any extent on ratings may be unknowingly bearing a risk for which he is not being compensated.²²⁶

It is generally recognised that conflicts of interest arise at both an individual rating analyst level and a rating agency level. However, debate is concentrated on whether the agencies can adequately manage these conflicts.²²⁷

Global regulators have affirmed that independence and conflicts of interest are the major concerns of rating procedures.²²⁸ In particular, CRA ratings decisions should be independent and free from political or economic pressures and from conflicts of interest arising due to the CRA's ownership structure, business or financial activities, or the financial interests of the CRA's employees.

The 2003 SEC Report noted that potential conflicts of interest arise as a result of the dependence of rating agencies on revenues from the companies they rate and the rating agencies' practice of charging fees based on the size of the

²²³ Corinna Coors, 'Credit rating agencies – too big to fail?' (2012) 27 *Journal of International Banking Law and Regulation* 1, 28.

²²⁴ Daniel M. Covitz and Paul Harrison, 'Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate' (2003) Board of Governors of the Federal Reserve System Research Paper Series No 2003-68, 1. The authors demonstrate that rating changes are not influenced by rating agency conflicts of interest but, rather, that they are motivated primarily by reputation-related incentives.

²²⁵ Carol Ann Frost, 'Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies' (2007) 22 *Journal of Accounting, Auditing & Finance* 3, 478.

²²⁶ Timothy E. Lynch (note 170) 247.

²²⁷ Simi Kedia, Shivaram Rajgopal and Xing Zhou, 'Did going public impair Moody's credit ratings?' <<http://ssrn.com/abstract=2343783>> accessed 1 June 2014, 1. The authors found that 'Moody's ratings are more favourable for clients where Moody's is likely to face larger conflicts of interest: (1) large issuers; (2) firms that are more likely to benefit from higher ratings, on the margin; and (3) in industries with greater competition from Fitch'.

²²⁸ IOSCO Technical Committee, 'Statement of Principles regarding the activities of Credit Rating Agencies' (25 September 2003). See also IOSCO Technical Committee, 'Report on the activities of credit rating agencies' (September 2003) 10-12.

issuance.²²⁹ More precisely, the 2003 SEC Report stressed that reliance by rating agencies on issuer fees leads to significant conflicts of interest or otherwise calls into question the overall objectivity of credit ratings.

A related potential conflict arises in the context of underwriters attempting to influence the credit rating process. In this regard, a large amount of bond offerings are underwritten by a few large firms, and a potential conflict exists for rating agencies to rate a particular underwriter's clients more favourably in return for future business.²³⁰

The main points of the 2003 SEC Report are the CRAs' reliance on the issuers of securities and the ratings inflation of those securities. It has been observed that 'rating an issuer's product increases the likelihood of an issuance being successful and therefore of the issuer continuing to thrive and therefore of future issuances with their associated fee payments taking place in the future'.²³¹

The development of ancillary businesses (rating assessment, risk management and consulting services) provided by CRAs has increased the catalogue of conflicts. For instance, prior to being issued with a public rating, issuers can purchase an 'indicative' or private rating, along with 'advice' regarding how the company might improve their rating.²³² Therefore, the purchase of ancillary services could affect the credit rating decision and issuers may be pressured into using them out of fear that their failure to do so could adversely impact their credit rating.²³³

The growth of the credit derivatives market created the possibility that the use of credit ratings in counterparty collateral arrangements could produce a strongly procyclical effect (this possibility was evident in the case of American International Group, Inc.).²³⁴ As a result, the boom of structured finance produced very significant and abrupt rating downgrades that determined the phenomenon of 'rating inflation'.²³⁵

²²⁹ SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets' (January 2003) 23.

²³⁰ *ibid* 41.

²³¹ House of Commons Treasury Committee, 'Banking Crisis: reforming corporate governance and pay in the City. Ninth Report of Session 2008–09' (2009) 71.

²³² Daniel M. Covitz and Paul Harrison (note 224) 6.

²³³ SEC (note 229) 43.

²³⁴ FSA, 'The Turner Review. A regulatory response to the global banking crisis' (2009) 76.

²³⁵ See the analysis carried out by Marco Pagano and Paolo Volpin, 'Credit ratings failures and policy options' (2010) 25 *Economic Policy* 62, 413-415. In particular, the authors observe that 'rating inflation benefits issuers only if at least some investors fail to take it into account in their

Such ‘ratings inflation’ was facilitated by the limited understanding of the risk of structured debt and by inaccurate information about the risk characteristics of the underlying assets.²³⁶ In other words, CRAs knew little or nothing about the underlying assets backing the securitised structures they were rating. Indeed, ‘structured products are designed to take advantage of different investor risk preferences; they are typically structured for each tranche to achieve a particular credit rating’.²³⁷

The conflicts are exacerbated when CRAs involve the executive officers of companies to discuss the rating methodology or when CRAs permit issuers to submit the details of a proposed structure to them and then advise the issuer of their likely ratings.²³⁸

It is generally considered that CRAs demonstrated the presence of conflicts of interest during the sub-prime mortgage crisis not only by giving their highest rating to most of the collateralised debt obligations (CDOs), but also by allowing issuers to consult raters on designing the CDOs.²³⁹

As just indicated, the underlying cause of these conflicts is located in the ‘issuer-pays’ business model. It is certainly the case that the agency compensation arrangement constitutes, on the face of it, a conflict of interest per se. Another reason could be found in the manifest shortcomings of the CRAs’ internal controls. With the huge expansion of structured finance (particularly derivative products), came a need for expert gatekeepers to evaluate them. The result has been the enormous profitability of credit rating agencies.²⁴⁰ It has been noted that a central difference between the ratings approach for traditional debt instruments and that for structured products is that the rating assessment for structured

investment decisions, either because they are naive or because their portfolio decisions are dictated by regulations prescribing investment in highly rated securities’.

²³⁶ John M. Griffin and Dragon Yongjun Tang, ‘Did Subjectivity play a Role in CDO Credit Ratings?’ (2012) 67 *The Journal of Finance* 4, 1325-1326. See also Jérôme Mathis, James McAndrews and Jean-Charles Rochet, ‘Rating the raters: Are reputation concerns powerful enough to discipline rating agencies?’ (2009) 56 *Journal of Monetary Economics* 5, 669; Patrick Bolton, Xavier Freixas and Joel Shapiro, ‘The Credit Ratings Game’ (2012) 67 *The Journal of Finance* 1, 109-110.

²³⁷ FSF, ‘Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience’ (2008) 33.

²³⁸ Andrew Johnston, ‘Corporate Governance is the problem, not the solution: A critical appraisal of the European regulation of credit rating agencies’ (2011) 11 *Journal of Corporate Law Studies* 2, 409.

²³⁹ Franklin Stryer, ‘Rating the Raters: Conflicts of Interest in the Credit Rating Firms’ (2008) 113 *Business and Society Review* 4, 533.

²⁴⁰ *ibid* 537.

products necessarily takes place *ex ante*.²⁴¹

The central question is the issuer-agency relationship that characterises the ratings business model. This relationship is confronted with major conflicts of interest questions because the interests of issuers in respect of their ratings do not often align with the needs of investors to receive reliable ratings information.²⁴²

In particular, conflicts arise when: (1) the issuer pays the CRA evaluating the issuer's bonds; (2) CRAs put in place consulting arrangements with the issuers of the bonds they rate; and (3) CRAs take up the incentive of issuing high fees and granting correspondingly high ratings to their clients as well as a corresponding disincentive to downgrade. Consequently, 'the rating agencies have a direct hand in defining the structure that a corporation must adhere to in order to have the lowest possible cost of funding'.²⁴³

Conflicts of interest take place when CRAs work closely with issuers in designing structured products that the same agency will later rate. Specifically, companies often use software and documents distributed by the rating agencies that provide in-house assistance as to how to satisfy the requirements for highest ratings.²⁴⁴ In other words, conflicts arise when agencies help their clients design structured products that they will later rate.²⁴⁵ For this reason, 'ratings became almost a matter of negotiation rather than one arm's length commercial judgement'.²⁴⁶

It is noteworthy that a rating downgrade provokes negative consequences in terms of loss of confidence in both the issuer and the rating agency. The consequences of a downgrade can be severe in cases when bonds do default. In the same way, a tardy downgrade can be less severe because the effects of

²⁴¹ Pragyant Deb, Mark Manning, Gareth Murphy, Adrian Penalver and Aron Toth (note 198) 10. The authors observe that 'if a particular product does not attract the desired rating, the issuer can tweak the structure and resubmit it for a revised rating assessment'.

²⁴² Charles W. Calomiris and Joseph R. Mason, 'Conflicts of Interest, Low-Quality Ratings, and Meaningful Reform of Credit and Corporate Governance Ratings' *Economic Policies for the 21st Century* (19 April 2010) 6. See also Charles W. Calomiris, 'The debasement of ratings: what's wrong and how we can fix it' *Economic Policies for the 21st Century* (26 October 2009) 10.

²⁴³ Joshua Rosner, 'Toward an Understanding: NRSRO Failings in Structured Ratings and Discreet Recommendations to Address Agency Conflicts' (2009) 14 *The Journal of Structured Finance* 4, 9.

²⁴⁴ In such case, the agency receives a separate fee for this 'consulting service'. See Franklin Strier (note 247) 537.

²⁴⁵ Sarah Johnson, 'SEC Relies on Rating Agencies, Too' (14 February 2008) <<http://www.CFO.com>> accessed 27 March 2012.

²⁴⁶ Harry McVea, 'Credit rating agencies, the subprime mortgage debacle and global governance: the EU strikes back' (2010) 59 *International & Comparative Law Quarterly* 3, 712-713.

imminent bonds failure can be better absorbed by issuers, for instance in the case of Enron.²⁴⁷ Covitz and Harrison observed that ‘the delay incentive should also be larger when the downgrade itself is particularly costly to the issuer’.²⁴⁸ Therefore, the desire to generate revenue alongside the explicit or implicit pressure from issuers increases rating inaccuracies.

In order to address the area of conflicts of interest the transparency of CRAs’ governance needs to be enhanced. This means stringent controls, greater disclosure, a balanced agency-client relationship, and independence from issuers. A full and thorough disclosure of rating services is not sufficient to ensure transparency in the bond ratings industry. To increase CRAs’ independence from the issuers whose instruments are being rated, an independent compliance body is needed. Such a compliance body could monitor the relationship with the client’s rating agency and evaluate the desirability of publishing a particular rating grade. Such an approach could favour the accuracy of the financial statement and realign the agency-client relationship.

In order to secure investor protection, a simple switch from the ‘issuer-pays’ model to a ‘subscriber compensation’ model is not a workable option. The problem with the ‘subscriber model’ is the loss of compensation from ‘free riders’ (i.e. all those who receive the information free of charge from the paying subscriber), who benefit from a free rating.

An option that could constitute a workable solution for managing conflicts could be using the compliance function. Using the compliance function rather than individuals to check ratings decisions and assigning a surveillance team—separate from the initial monitoring team—to track credit ratings after their initial issuance.²⁴⁹

The compliance function in CRAs governance could stop the ratings from being a precondition for the sale of structured securities and reduce the CRAs’ influence in advising issuers about how to structure securities in order to achieve the rating desired. It is undeniable that conflicts of interest have greater potential market implications and should be managed by appropriate regulatory oversight.

²⁴⁷ Clair A. Hill, ‘Rating Agencies Behaving Badly: The Case of Enron’ (2003) 35 *Connecticut Law Review* 3, 1148-1151.

²⁴⁸ Daniel M. Covitz and Paul Harrison (note 224) 7.

²⁴⁹ Dawn Kopecki, ‘The Credit Ratings Blame Game’ *Businessweek* (28 September 2007) <<http://www.businessweek.com>> accessed 27 March 2012.

The establishment of an independent compliance department should foster ratings stability as it would be objective, consistent, replicable, and removed from potential conflicts of interest. A compliance function would be separated from ‘modelling staff’ and would be responsible for the integrity of reporting lines. For instance, compliance officers may detect whether employees of rating agencies are involved in possibly inappropriate rating actions.

Inevitably, of course, the intent to reduce the risk of analyst conflicts of interest and ensure the objectivity and quality of analyst ratings represents the major challenge of regulators.²⁵⁰ The US Credit Rating Agency Reform Act 2006 introduced a new Section, namely 15E that requires a NRSRO to establish, maintain, and enforce written policies and procedures to address conflicts of interest.²⁵¹ Section 15E requires a NRSRO to provide information, including any conflict of interest relating to the issuance of a credit rating by the rating agency, to the SEC upon filing the registration statement by the rating agency for its NRSRO recognition (Section 15E(a)(1)(B)(vi) of the Exchange Act). In addition, Section 15E(h) of the Exchange Act requires ‘applicants for NRSRO and existing NRSROs to establish, maintain, and enforce procedures to address and manage conflicts of interest’.

In the EU, Regulation (EU) No 462/2013 introduces specific rules aiming to reduce long-lasting relationships between rated entities and CRAs. Above all, it seeks to restore the impartiality and independence of CRAs.²⁵² Recital 22 in the preamble to Regulation (EU) No 462/2013 states that ‘credit rating agencies should establish, maintain, enforce and document an effective internal control structure [such as] Standard Operating Procedures (SOPs) relating to corporate governance, organisational matters, and the management of conflicts of interest’.²⁵³

Article 6(1) of the 2013 CRA Regulation places an obligation on registered

²⁵⁰ The SEC Commission has recently launched a task force to avoid the risks of analyst conflicts; however, some criticisms of this regulatory approach have recently been expressed. See Joshua Rosner (note 243) 17.

²⁵¹ In particular, Section 15E(h)(1) of the Exchange Act establishes that ‘each nationally recognized statistical rating organization shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such nationally recognized statistical rating organization and affiliated persons and affiliated companies thereof, to address and manage any conflicts of interest that can arise from such business’.

²⁵² Recital 12 in the preamble to Regulation (EU) No 462/2013.

²⁵³ Recital 22 in the preamble to Regulation (EU) No 462/2013.

CRAs to ensure that credit ratings are not affected by any existing or potential conflicts of interest.²⁵⁴ Annex I, section B (1), to Regulation (EU) No 462/2013, requires CRAs to identify and eliminate or, where appropriate, manage and subsequently disclose, any actual or potential conflicts of interest which may influence the analyses and judgements of their analysts or employees when determining or approving credit ratings and rating outlooks.

At international level, IOSCO issued a set of principles regarding CRAs' independence and the avoidance of conflicts of interest.²⁵⁵ In particular, greater attention is paid to CRAs' internal procedures and policies.

However, public regulators tend to delegate governance tasks and regulatory authority to specialised agents—the gatekeepers—for measuring financial risks. This kind of delegation occurs 'if the perceived benefits of making use of credit rating agencies' resources through delegation are greater than the perceived agency losses'.²⁵⁶

At this point, the root of the question is the degree of independence of the agents from the principals. Generally, agents follow the *principal's* instructions or adopt the *principal's* decisions. The major concern is that the principals are investors. In this context, it can be claimed that the 'principal-agent theory' confirms that the principal-agent arrangement occurs when the agent has incentives to manage the asset in the best way for the principal.²⁵⁷ This is because such opportunistic behaviours arise as the agent exercises his or her expertise, i.e. discretion, in a way which maximises his or her own interests, rather than those of the principal. These elements are clearly applicable to the rating agencies' activities.

It is clear that conflicts of interest in the issuer-agency relationship increase and favour rating shopping. It also reveals collusive or strategic behaviour in respect of investors.²⁵⁸ Therefore, 'regulatory intervention is needed to eliminate or at least minimise rating agencies' incentives to engage in inappropriate rating

²⁵⁴ Article 6(1) of Regulation (EU) No 462/2013.

²⁵⁵ IOSCO Technical Committee, 'Code of Conduct Fundamentals for Credit Rating Agencies', May 2008, 7-8.

²⁵⁶ Andreas Kruck (note 148) 81.

²⁵⁷ Robert Cooter and Thomas Ulen, *Law & Economics* (5th ed, Pearson International Education 2008) 431-433.

²⁵⁸ Patrick Bolton, Xavier Freixas and Joel Shapiro, 'The Credit Ratings Game' (2009) National Bureau of Economic Research, Working Paper No 14712 <<http://www.nber.org/papers/w14712>> accessed 28 March 2012, 2.

actions and to maximize the investing public's awareness of risks that arise from such conflicts of interest'.²⁵⁹ A viable solution for avoiding conflicts of interest in rating would be to establish internal operating procedures and analyst compensation policies that reduce the link between salary and fee revenue.²⁶⁰ As Sinclair has noted, 'making issuers pay introduces the potential for issuers to influence the agencies' judgements and undermine their commitment to giving investors a true account'.²⁶¹

In academic circles, another option has been proposed to regulate conflicts of interest. This is to establish a 'winner-take-all bonus scheme', a funding mechanism that should augment the issuer-pay business model. In this way, 'a small, recurring portion of revenue earned by the largest rating agencies should be ceded to fund a pay-for-performance bonus, and that the agencies should compete for this bonus on a periodic winner-take-all basis'.²⁶² However, this option does not seem workable because rating agency employees might not be sufficiently encouraged to perform better simply by the prospect that their agency might win a bonus pool.²⁶³ CRAs might well argue that 'keeping the client happy is a better use of effort than trying to get ratings right'.²⁶⁴

After providing an analysis of CRAs' conflicts of interest, the following section focuses on the question of compensation for CRAs taking into account suggestions for reform designed to implement an alternative business model for CRAs.

2.4.1 *Alternative methods of compensation for CRAs*

In recent decades, it has become questionable whether CRAs act in the interests of market participants or in the interests of those who provide their high fees.²⁶⁵ It is also debatable whether CRAs form an independent assessment of a

²⁵⁹ Lynn Bai (note 173) 270.

²⁶⁰ Roy C. Smith and Ingo Walter, 'Rating Agencies: Is There an Agency Issue?' (February 2001) New York University Stern School of Business, 44.

²⁶¹ Timothy J. Sinclair (note 156) 151.

²⁶² Robert J. Rhee, 'On duopoly and compensation games in the credit rating industry' (2013) 108 *Northwestern University Law Review* 1, 85.

²⁶³ Claire A. Hill, 'The motivating force of a bonus pool, and other objections' (2014) 108 *Northwestern University Law Review Online* 271, 277.

²⁶⁴ *ibid* 276.

²⁶⁵ Stefan Ingves, 'The role of credit rating agencies from a central banker's perspective' in Jan Kleineman, Lars Gorton and Aron Verstandig (eds), *Perspectives on Credit Rating Agencies*

borrower's relative creditworthiness and whether they are still considered a valuable benchmark of financial products as CRAs use publicly available data to assess the default risk of debt instruments.²⁶⁶

These uncertainties question whether CRAs contribute towards financial stability²⁶⁷. After all, as intermediaries, they should provide correct information about the market value and creditworthiness of debt securities.

Ratings do not provide any information as to whether a particular debt is repayable at a future date (e.g. the default of the rated debtor) and whether the obligation is suitable for investors.²⁶⁸ By contrast, CRAs issue ratings at the issuer's request and are then monitored by internal methodologies that provide an evaluation of the default risk of financial products.

The rise of CRAs as leading actors in the financial community leads to the consideration that credit ratings have assumed the status of financial institutions and occupy a privileged regulatory position. This status has been primarily determined by the weakness of global regulators (and supervisory authorities) to oversee the capital markets, an environment that runs the risk that the ordinary centres of financial regulation are being replaced by private decision-making mechanisms.²⁶⁹

Although the securities markets relied on the 'issuer-pays' fee model, empirical studies have found that investor-paid ratings created a stronger incentive for CRAs to publish changes in ratings faster than the issuer-paid remuneration structure.²⁷⁰

According to these findings, it seems appropriate that CRAs should receive fees in proportion to the value of the information they provide to the investors (i.e.

(Stockholm: Författarna, Stockholm Centre for Commercial Law Jure Förlag AB 2013) 25.

²⁶⁶ Tracy Alloway, 'Sunshine-backed bond to go on sale' *Financial Times* (London, 4 November 2013), where it is reported how in a solar panel deal the CRAs assessment can be relevant as 'Deutsche Bank, Credit Suisse and JPMorgan are marketing the "Reo-to-rental" after securing a surprise triple-A rating from Moody's, Morningstar and Kroll for the bonds'.

²⁶⁷ Jone Engh, 'Control of ownership in credit rating agencies' in Jan Kleinman, Lars Gorton and Aron Verstandig (eds), *Perspectives on Credit Rating Agencies* (Stockholm: Författarna, Stockholm Centre for Commercial Law Jure Förlag AB 2013) 155-156.

²⁶⁸ *Cassa di Risparmio della Repubblica di San Marino SpA v Barclays Bank Ltd* [2011] EWHC 484 (Comm) at 45.

²⁶⁹ Bartholomew Paudyn, 'Credit rating agencies and the sovereign debt crisis: Performing the politics of creditworthiness through risk and uncertainty' (2013) 20 *Review of International Political Economy* 4, 801-803.

²⁷⁰ Andreas Milidonis, 'Compensation incentives of credit rating agencies and predictability of changes in bond ratings and financial strength ratings' (2013) 37 *Journal of Banking & Finance* 9, 3729.

subscribers) but, since they act as intermediaries by supplying a public good to the financial markets, their informational service should be remunerated through a fixed system of revenues.²⁷¹ This method of compensation may reduce the discretionary and extensive use of ratings as a contractual signal of a borrower's creditworthiness. What is more, it may avoid an increased dependence on the issuer fees model or the bond's ability to receive a desired rating.

As a result, revenues should no longer be viewed as compensation for the CRAs' 'seals of approval' for those companies needing access to the capital markets. Instead, revenue should be regarded as the remuneration for the financial intermediary service provided to issuers.²⁷²

The increasing reliance on CRAs' performances has led to 'deluded' processes to calculate the risks of asset-backed securities and exacerbated the systemic risk in the financial markets.²⁷³ In particular, it has been observed that 'rating agencies are "glossing over" risks when assigning ratings to asset-backed securities by failing to take into account adequate counterparty risk'.²⁷⁴

The 2007-2009 financial crisis highlighted the failures of ratings methodologies for securities. They tended to be too focused on whether the underlying asset pool was profitable and not enough on the quality of the underlying pool.²⁷⁵ The catalogue of recent CRAs' shortcomings highlighted the point that credit ratings should not affect issuers' access to capital or the decisions of investors. Conversely, they should provide independent assessments of financial instruments.

²⁷¹ In June 2008, a big step forward against the 'issuers-pays model' was reached with the adoption of the 'Cuomo agreement'. The agreement—signed between Attorney General Andrew M. Cuomo and the main CRAs—requires that the agencies be paid upfront for their rating, and not contingent on the report. See Jérôme Mathis, James McAndrews and Jean-Charles Rochet, 'Rating the raters: Are reputation concerns powerful enough to discipline rating agencies?' (2009) 56 *Journal of Monetary Economics* 5, 669.

²⁷² Josh Wolfson and Corinne Crawford, 'Lessons From The Current Financial Crisis: Should Credit Rating Agencies Be Re-Structured?' (2010) 8 *Journal of Business & Economics Research* 7, 87.

²⁷³ Eric S. Pendergraft, 'Section 933(b): Nimble Private Regulation of the Capital Market Gatekeepers' (2012) 39 *Florida State University Law Review* 2, 514-515.

²⁷⁴ Madison Marriage, 'Ex-Moody's staff raise alarm over ABS 'meltdown' *Financial Times* (London, 10 November 2013).

²⁷⁵ A. Brooke Murphy, 'Credit Rating Immunity? How the Hands-Off Approach Toward Credit Rating Agencies Led to the Subprime Credit Crisis and the Need for Greater Accountability' (2010) 62 *Oklahoma Law Review* 4, 742-744.

After providing a brief analysis of the possible alternative methods of compensation for CRAs, the next section offers a critical appraisal of the ratings information system, taking into account the potential risks of disclosure failure.

2.4.2 *The disclosure regime*

Information disclosure represents a key aspect of CRA governance. CRAs publicly disclose some of the core methodology and the basic rationale used to conduct their credit analysis. In theory, credit ratings provide valuable information to those investors who have relatively limited information—gathering or analysis capacity and therefore cannot make credit evaluations as effectively as the agencies themselves. In particular, CRAs can be of particular benefit to investors who do not have a direct negotiating relationship with the issuer.

The ratings industry was largely unregulated in terms of mandatory due diligence and informational accuracy for their analysis.²⁷⁶ Global regulators have shown a manifest reluctance to provide mandatory rules that require rating agencies to check the quality and integrity of the information with which they are provided by the issuing firms.²⁷⁷ Poor due diligence, a lack of research resources (or lack of analytical resources) as well as *bona fide* mistakes are the major criticisms levelled against the activities of the CRAs.

Corporate financial scandals (e.g. Enron, WorldCom and Lehman Brothers) have illustrated a lack of due diligence and deficiency in the evaluation of corporations' creditworthiness. The scandals referred to above revealed the CRAs' abuses in respect of investor reliance. Further, rating governance appeared to be defective in terms of investor protection. This problem is made worse by inadequate internal control rules.²⁷⁸

While the purpose of a CRA is to reflect the creditworthiness of an issue or

²⁷⁶ The Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act of 2010) has amended Section 15E of the Securities Exchange Act to enhance the regulation and oversight of NRSROs by imposing new reporting, disclosure, and examination requirements. See SEC, '2011 Summary Report of Commission Staff's examinations of each Nationally Recognized Statistical Rating Organization' (September 2011) 2.

²⁷⁷ For instance, the 2004 IOSCO Code issued a set of principles for the activities of credit rating agencies enhancing a self-regulation approach and 'comply or explain' system.

²⁷⁸ ESMA, 'Credit Rating Agencies. ESMA's investigation into structured finance ratings', ESMA/2014/1524, 16 December 2014, 4-5. See also ESMA, 'Technical Advice. In accordance with Article 39(b) 2 of the CRA Regulation regarding the appropriateness of the development of a European creditworthiness assessment for sovereign debt', ESMA/2014/850rev, 17 September 2014, 4-5 and 11-12.

issuer, the CRAs have some discretion in their rating system and are not required to make their rating methodology public.²⁷⁹

The current regulatory framework for NRSROs requires mandatory disclosures be made by CRAs as to their rating policies and methodology.²⁸⁰ However, it involves very little direct oversight of the performance of a NRSRO for the purpose of preventing or punishing poor performance.

The SEC rules require only disclosure of the rating agencies' policies regarding verification of underlying assets and information. The usefulness of such general disclosure is likely to be limited because they could be written in a way that would allow a significant amount of deviation in the use of information and the extent of verification among similarly situated asset backed securities.²⁸¹

The SEC regulation introduced some disclosure requirements for CRAs. The purposes of these rules are predicated on the fact that they enhance the reputational cost to rating agencies that engage in inappropriate rating actions, and that they help to break the entry barrier for smaller rating agencies with strong performance records in a market that is dominated by the main CRAs.²⁸² It has been argued that a major function of CRAs is to certify to relatively uninformed traders that they do not face a significant informational disadvantage, though most 'customers' of CRAs are sophisticated (such as investment banks, alternative investments and sovereign wealth funds).²⁸³

The desired end product is that the principal role of reputational intermediaries is to guarantee disclosure quality and thereby reduce information asymmetry in securities markets. However, information asymmetry in the market for reputational intermediaries hampers their ability to play this role.²⁸⁴

At EU level, Regulation (EU) No 462/2013 establishes a set of rules imposing obligations on issuers, originators and sponsors in connection with structured

²⁷⁹ Deryn Darcy, 'Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict contributed and what Regulators might do about it' (2009) *Columbia Business Law Review* 2, 648.

²⁸⁰ Kia Dennis, 'The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis' (2009) 63 *University of Miami Law Review* 4, 1144.

²⁸¹ *ibid* 1145.

²⁸² Lynn Bai, 'The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?' (2010) 7 *NYU Journal of Law & Business* 1, 51.

²⁸³ Dion Bongaerts, K. J. Martijn Cremers and William N. Goetzmann, 'Multiple Ratings and Credit Spreads' (2009) National Bureau of Economic Research, Working Paper Series No 15331 <<http://www.nber.org/papers/w15331>> accessed 16 May 2012, 4.

²⁸⁴ Bernard S. Black, 'The Legal and Institutional Preconditions for Strong Securities Markets' (2001) 48 *UCLA Law Review* 4, 788.

finance instruments.²⁸⁵ Article 8b(1) of the 2013 CRA Regulation requires the issuer, the sponsor and the originator of a structured finance instrument established in the Union to publish on the website set up by ESMA²⁸⁶ extensive information on the credit quality and performance of the underlying assets of the structured finance instrument.²⁸⁷

The law seeks to establish some safeguards. Article 8c(1) of the 2013 CRA Regulation requires that the issuer that intends to solicit a credit rating of a structured finance instrument has to select at least two CRAs to provide credit ratings independently of each other.²⁸⁸ These provisions aim to enhance disclosure of information on structured finance instruments and address the potential collusive behaviour in the CRA-issuer business relationship. As Darbellay has observed, ‘the structured finance segment highlights how the rating industry became very profitable without providing investors with valuable information’.²⁸⁹

In addition, Article 10(1) of the 2013 CRA Regulation requires the credit rating agency to disclose ‘any credit rating or rating outlook, as well as any decision to discontinue a credit rating, on a non-selective basis and in a timely manner’.²⁹⁰

Policymakers are primarily relying on disclosure of the potential conflicts of interest and of the procedures a CRA has in place for managing the issuers’ information. Disclosure per se is not a guarantee that investors will necessarily be able to take full advantage. As Darcy noted ‘even if CRAs are fully and fairly making mandatory disclosures on the issuer pays conflict, investors must adequately perceive and evaluate that information and must penalize CRAs via the market mechanism if disclosure is to adequately deter the agencies from

²⁸⁵ Recital 30 in the preamble to Regulation (EU) No 462/2013. See also White & Case, ‘The credit rating market for structured finance instruments: new requirements for issuers, originators and sponsors’, June 2013, 2 where ‘a structured finance instrument is defined as a financial instrument or other asset resulting from a securitisation transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranching, having the following characteristics: (1) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and (2) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme’.

²⁸⁶ Article 8b(4) of Regulation No 462/2013 requires ESMA to set up a website for the publication of the information on structured finance instruments.

²⁸⁷ Article 8b(1) of Regulation No 462/2013.

²⁸⁸ Article 8c(1) of Regulation No 462/2013.

²⁸⁹ Aline Darbellay, *Regulating Credit Rating Agencies* (Cheltenham: Edward Elgar 2013) 95.

²⁹⁰ Article 10(1) of Regulation No 462/2013. See also Annex I, Section D to Regulation No 462/2013 where CRAs are required to disclose sources; methodologies; meaning; limitations of ratings and any limitations of data on which they based.

reaping the gains of compromised ratings'.²⁹¹

When CRAs review and examine financial statements, it has the effect of renting out CRAs' reputations for conducting a careful evaluation that can locate fraud and discourage any attempts of fraud, and for painting a tolerably accurate picture of a company's performance. In this way, liability risk reinforces the rating firm's concern for reputation and can persuade the CRA to establish internal procedures to ensure the transparency of the financial statements.

Reputation markets require a mechanism for distributing information about the performance of companies and reputational intermediaries. Disclosure rules could help, as do reputational intermediaries' incentives to advertise their successes. Predictably, however, intermediaries will not publicise their own failures, and investors will discount competitors' complaints because they come from a biased source.

The securities regulator's role in adopting disclosure rules is undoubtedly important but it is only one pillar within the wider scheme which needs to be complemented by other rules and regulations. The core regulatory role is that of enforcing standards of conduct against issuers and reputational intermediaries who flagrantly violate the disclosure rules. Tweaking those rules at the margin is no substitute for the core role.

After considering the CRAs' disclosure system, the ensuing sections provide an analysis of the key aspects of CRAs' governance, namely transparency and market competition, emphasizing the response of regulators and bringing forth proposals to enhance the ratings fairness.

2.5 Transparency and fairness of CRAs

In assessing corporate default risk, creditors and financial analysts have a need to access transparent financial information. Transparency is essential to clear up not only the opacity involving the agencies' methodologies, but also both the perceptions and misconceptions surrounding unsolicited ratings activity.

The SEC adopted a series of rules further to enhance the transparency of rating methodologies and performances and to strengthen NRSROs' recordkeeping and reporting obligations, in order to assist the SEC in monitoring NRSROs'

²⁹¹ Deryn Darcy (note 279) 653.

compliance with regulation.²⁹²

The US normative framework requires each CRA registered as an NRSRO to disclose its rating performance in terms of historical default rates and rating transitions.²⁹³ An important component of the CRA regulation is the requirement that CRAs disclose statistics that measure the accuracy of their ratings and their historical rating assessments.

The normative US schemes for CRAs sought to fulfil the transparency gap in relation to the ratings process, as well as the rigour and consistency of the methodologies used by CRAs. However, the process of obtaining NRSRO status has been criticised for its lack of transparency regarding qualifications and for effectively limiting the number of certified CRAs.²⁹⁴

At EU level, CRAs are required to complete and publish an annual ‘transparency report’. This contains detailed information about a CRA’s legal structure and ownership, internal quality control systems, record-keeping policies, description of its management and rating analyst rotation policy.²⁹⁵

A rating agency’s reputation would tend to be bolstered if it avoided conflicts of interest when the rating agency is owned, managed, or influenced by the institutions being rated. In this respect, the Council of the European Union published a general position to mitigate the risk of conflicts of interest.²⁹⁶ Regulation (EU) No 462/2013 introduced specific provisions to address conflicts of interest concerning investment in CRAs.²⁹⁷ It should be underlined that the task force launched by Community regulations aimed to reinforce ESMA’s power of supervision.²⁹⁸

²⁹² Tin A Bunjevca, ‘Credit Rating Agencies: A Regulatory Challenge for Australia’ (2009) 33 *Melbourne University Law Review* 1, 47.

²⁹³ Lynn Bai (note 282) 79.

²⁹⁴ Elizabeth Devine, ‘The collapse of an empire? Rating agency reform in the wake of the 2007 financial crisis’ (2011) 16 *Fordham Journal of Corporate & Financial Law* 1, 191-192.

²⁹⁵ Regulation No 446/2012 (OJ 2012 L 140 p. 2); Regulation No 447/2012 (OJ 2012 L 140 p. 14); Regulation No 448/2012 (OJ 2012 L 140 p. 17); and, Regulation No 449/2012 (OJ 2012 L 140 p. 32).

²⁹⁶ Council of the European Union, ‘Credit rating agencies: General approach agreed ahead of talks with EP’, Presse 214, Brussels, 21 May 2012. In detail, the proposal required CRAs to disclose publicly if a shareholder with 25 percent or more of the capital or voting rights holds 25 percent or more of the rated entity. Additionally, this proposal aimed to ensure the diversity and independence of credit ratings and opinions, prohibiting ownership of 25 percent or more of the capital or the voting rights in more than one CRA.

²⁹⁷ Article 6a of Regulation (EU) No 462/2013.

²⁹⁸ Regulation No 447/2012 of 21 March 2012 ‘supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council on credit rating agencies by laying down regulatory

Regulation (EU) No 462/2013 provides detailed provisions for implementing measures aimed at increasing the transparency of CRAs' internal governance.²⁹⁹ Article 11a(1) of the 2013 CRA Regulation established the European Rating Platform where 'a registered or certified credit rating agency shall, when issuing a credit rating or a rating outlook, submit to ESMA rating information including the credit rating and rating outlook of the rated instrument, information on the type of credit rating, the type of rating action, and date and hour of publication'.³⁰⁰

In addition, CRAs are required to disclose the outcome of the annual internal review of its independent compliance function and financial information on the revenue of the credit rating agency.³⁰¹ Most importantly, CRAs must disclose the details of their ownership structure and clients in order to facilitate transparency. After all, disclosure per se is a manifestation of control over informational assets such as ratings.³⁰²

It is noteworthy that the main CRAs do not have independent ownership structures. Fitch IBCA is jointly owned by Hearst Corporation, a US multinational mass media group based in New York and FIMALAC S.A., a French financial conglomerate. Similarly, S&P's is a unit of McGraw-Hill Companies, Inc., an influential publishing and media company while Moody's Investors Service has been managed for several decades by Dun & Bradstreet³⁰³, a leading US business information company.

The ownership composition of the main CRAs casts considerable doubt as to the outright independence of rating activities. The aforementioned owners of CRAs are powerful companies listed in the securities markets. This means that they play an active role in the financial sectors and may put pressure on financial transactions. In particular, McGraw-Hill Companies, Inc. and FIMALAC S.A. are

technical standards for the assessment of compliance of credit rating methodologies' (OJ 2012 L 140 p. 14).

²⁹⁹ Annex I, Section E to Regulation No 1060/2009 as amended by Regulation No 462/2013.

³⁰⁰ Article 11a(1) of Regulation (EU) No 462/2013. See also recital 31 in the preamble to Regulation (EU) No 462/2013 that states 'the European rating platform should incorporate ESMA's central repository with a view to creating a single platform for all available credit ratings per instrument and for information on historical performance data, published on the central repository'.

³⁰¹ ESMA, 'Final Report on Draft Regulatory Technical Standards (RTS) under the CRA3 Regulation', 20 June 2014.

³⁰² Antoine Faure-Grimaud, Eloïc Peyrache and Lucía Quesada, 'The ownership of ratings' (2009) 40 *RAND Journal of Economics* 2, 235.

³⁰³ Moody's business was acquired by Dun & Bradstreet in 1962. In 2000, Moody's Investors Service became a separate company (Moody's Corporation was established as a holding company).

dominant firms in the information network, providing business services (i.e. business information reports) and publishing financial magazines. The worldwide business information group Dun & Bradstreet (Moody's main shareholder) has set up subsidiaries in every European country and generally has a large stake in the local markets for business information.

These factors can be significant in respect to the type of claim rated by the main CRAs. For instance, Fitch has expertise in the areas of debt, preferred stock of corporations, sovereigns, governments and structured financing. Moody's has experience in handling bonds (sovereigns, corporations, financial institutions, pooled investment vehicles, structured finance, thrifts, public finance), bank deposits and commercial paper. S&P's has experience in managing bonds from corporations, financial institutions, infrastructure finance, insurance, managed funds, public finance, sovereigns and structured finance.

Other sources of credit risk assessment, particularly in the banking system, such as Central Credit Registers (CCRs)³⁰⁴ and Central Financial Statements Databases (CFSDs),³⁰⁵ are owned and managed by the National Central Banks (NCBs) of the EU Member States. They are mainly influenced by the banking industry and their management is shared by the NCBs. These rating institutions play a significant role for credit institutions because they offer banks a useful instrument for monitoring customers' exposure and comparing their lending policy with that of competitors.³⁰⁶

Devine suggested that the most effective approach in arriving at a more transparent rating system could be a two-step due diligence requirement by which professionals employed by issuers and underwriters provide complete and verified data to the rating agencies.³⁰⁷ In essence, transparent financial information and disclosures can be achieved by adopting effective, internal control systems and by

³⁰⁴ The service provided by Central Credit Registers (CCRs) involves collecting, processing, managing and releasing information on banks' credit exposures. The general goal of CCRs is to enhance the transparency of banking activities and make those activities secure.

³⁰⁵ The Central Financial Statements Databases (CFSDs) service involves the credit quality of counterparties to which banks are exposed. CFSDs are generally used to determine eligibility of corporate debt instruments in central banks' banking refinancing procedures, banking supervision, and economic research.

³⁰⁶ Basel Committee on Banking Supervision, 'Credit Ratings and Complementary Sources of Credit Quality Information' (August 2000) Working Papers No 3, 55-61.

³⁰⁷ Elizabeth Devine (note 294) 198.

promoting the value policies of the firm.³⁰⁸

2.6 *The question of market competition*

The maintenance of accuracy of a CRA's ratings is incentivised by its need to preserve its reputation and by competition. However, it is generally considered that competition can both aid and hinder reputational commitments for quality.³⁰⁹ Limited competition creates barriers to entry for additional competitors for two main reasons: (1) investor demand for global coverage with consistency in ratings; and (2) the 'regulatory licence' enjoyed by a limited number of CRAs.

The lack of competition in the ratings industry brings with it a number of problems. These include inflated issuance fee levels, limiting innovation in ratings methodologies, and the heightened chance that, with so few significant players, major occurrences in the market can be missed.³¹⁰ Competition from investors' perspectives could reduce bias because of the pressure to be accurate. However, competition need not reduce, and indeed may increase bias, if consumers want to hear reports that conform to their perceptions.³¹¹

Merely enhancing more NRSROs does not mean there will be more competition.³¹² Smaller firms and new entrants face the significant problem of developing the very reputational capital that the current NRSROs claim is so central to their continued operation and success. Some commentators observe that increasing the number of CRAs would, in fact, worsen the shopping problem and reduce welfare.³¹³ Following this view, the fostering of new entries into the ratings business may not necessarily make it more efficient in terms of rating quality.³¹⁴

The reward for maintaining a sound reputation would be lower because

³⁰⁸ Samir M. El-Gazzar, Kwang-Hyun Chung and Rudolph A. Jacob, 'Reporting of Internal Control Weaknesses and Debt Rating Changes (2011) 17 *International Advances in Economic Research* 4, 421.

³⁰⁹ Heski Bar-Isaac, 'Imperfect Competition and Reputational Commitment' (2005) 89 *Economics Letters* 2, 167.

³¹⁰ Angus Duff, 'The credit ratings agencies and stakeholder relations: issues for regulators' (2009) 24 *Journal of International Banking and Financial Law* 1, 12.

³¹¹ Harrison Hong and Marcin Kacperczyk, 'Competition and bias' (2008) Working Paper <<http://ssrn.com/abstract=1101626>> accessed 16 May 2012, 1.

³¹² *ibid* 30.

³¹³ Vasiliki Skreta and Laura Veldkamp, 'Ratings shopping and asset complexity: A theory of ratings inflation' (2009) 56 *Journal of Monetary Economics* 5, 678-680.

³¹⁴ Jerome S. Fons, 'Rating Competition and Structured Finance' (2008) 14 *The Journal of Structured Finance* 3, 9.

competition implies that the market is shared between larger numbers of CRAs.³¹⁵ Consequently, there is no particular reason to believe that new CRA entries would improve the quality of ratings. Goodhart has contested this, arguing that ‘a new entrant could establish a track record for greater accuracy—independently assessed—in a particular niche by exploiting a comparative advantage, say in rating one particular product line, with a small staff, and then build from that’.³¹⁶

Others, for their part, have observed that competition among specialised financial intermediaries can lead to full and credible information disclosure, even in the presence of only small reputation costs.³¹⁷ On this view, this is predicated on the fact that competition fosters the provision of information and reduces conflicts of interest. Competition should be encouraged so that all agencies which are recognised and used by the market operate on a level playing field. That means the markets must also open their processes to new or specialist agencies and not rely on the main CRAs.

At EU level, Regulation (EU) No 462/2013 seeks to encourage the use of smaller CRAs in order to increase competition in the credit ratings industry. Recital 11 in the preamble to the 2013 CRA Regulation provides that ‘...where two or more credit ratings are sought, the issuer or a related third party should consider appointing at least one credit rating agency which does not have more than 10 % of the total market share’.³¹⁸

Article 6b of the 2013 CRA Regulation sets out a maximum duration of the contractual relationship between the rated entity and the CRA. It requires a rotation mechanism to mitigate the risk of entering a dynamic whereby an issuer refrains from changing credit rating agency as this could raise the concerns of investors regarding the issuer’s creditworthiness (‘lock-in effect’).³¹⁹

³¹⁵ Nelson Camanho, Pragyant Deb and Zijun Liu, ‘Credit Rating and Competition’ (2010) London School of Economics Financial Markets Group, Discussion Paper No 653, 2.

³¹⁶ Charles A E Goodhart, ‘How, if at all, should Credit Ratings Agencies (CRAs) be Regulated?’ (June 2008) LSE Financial Markets Group Paper Series, Special Paper No 181, 31-32.

³¹⁷ Patrick Bolton, Xavier Freixas and Joel Shapiro, ‘Conflicts of interest, information provision, and competition in the financial services industry’ (2007) 85 *Journal of Financial Economics* 2, 298. The authors observe that ‘competition both reduces the gains from lying and induces financial institutions to disclose information in order to differentiate their products and thus relax price competition’.

³¹⁸ Recital 11 in the preamble to Regulation (EU) No 462/2013. See also Article 8d(1) of Regulation (EU) No 462/2013 that regulates the use of multiple credit rating agencies.

³¹⁹ Article 6b of Regulation (EU) No 462/2013.

In addition, the 2013 CRA Regulation requires that where a CRA enters into a contract for the issuing of credit ratings on re-securitisations, it shall not issue credit ratings on new re-securitisations with underlying assets from the same originator for a period exceeding four years.³²⁰ Clearly, the EU legislator aims to increase competition on the credit rating market for re-securitisations³²¹, a segment of the financial markets that betrayed serious failures during the 2007-2009 crisis on the part of the main CRA players. The rotation mechanism should facilitate new market entries and offer existing credit rating agencies the opportunity to extend their business to new areas.

In this regard, the EU Commission adopted a Report ‘on the feasibility of a network of smaller credit rating agencies’ which assesses how the establishment of such a network could contribute to the strengthening of smaller CRAs, facilitating their growth so as to become more competitive market players.³²²

Above all, it seems clear that without competitive pressure, rating agencies are unlikely to change their methodologies. The regulators should focus their efforts on increasing the number of players (i.e. the ‘inside pressure’).³²³ More new CRAs mean more competition, but more established and reputable CRAs are a safer bet for high quality ratings because they have more to lose from a recognition withdrawal.³²⁴ Since such competition could hardly do any harm from the allocation perspective, it is certainly sensible for the regulators to take up the cause of competition increasing measures. However, are CRAs truly essential in order to secure investor confidence? As Darbellay has noted, ‘lack of competition in the ratings market persists as long as market participants have little alternative but to rely on credit rating agencies despite their poor performance’.³²⁵

Several potential problems of efficiency and anticompetitive behaviour would

³²⁰ Recital 15 in the preamble to Regulation (EU) No 462/2013.

³²¹ “A re-securitisation is a securitisation where the risk associated with an underlying pool of exposures is tranching and at least one of the underlying exposures is a securitisation position”. See on this definition White & Case (note 285) 2.

³²² European Commission, ‘Report from the Commission to the Council and the European Parliament on the feasibility of a network of smaller credit rating agencies’ COM(2014) 248 final, Brussels, 5 May 2014.

³²³ Fabian Dittrich (note 189) 137. The author observes that ‘one has to accept that the credit rating industry is framed by exceptionally strong forces hindering competition – it is a natural oligopoly at best’ (at 138).

³²⁴ *ibid* 141.

³²⁵ Aline Darbellay, ‘Competition and Credit Rating Agencies’ in Jan Kleineman, Lars Gorton and Aron Verstandig (eds), *Perspectives on Credit Rating Agencies* (Stockholm: Författarna, Stockholm Centre for Commercial Law Jure Förlag AB 2013) 159.

be ameliorated by more competition. However, the principal fear of increased competition is a breakdown of the reputation mechanism that could lead to a deteriorating quality of ratings in the system.³²⁶ Hunt observed that ‘in the rating market, where quality presumably cannot be determined in advance, quality is rewarded because high-quality producers amass reputational capital’.³²⁷ More competition per se is not a solution because: (1) new CRAs do not have reputational capital; and (2) this can lead to rating inflation by the new CRAs in order to build their reputational capital.

The next section addresses the main questions relating to the use of rating triggers in financial transactions and the ‘certification’ role of CRAs.

2.7 The widespread use of ‘rating triggers’ in financial contracts

The regulatory use of references to credit ratings in legislation and the incorporation of credit ratings into private contracts increase the reliance placed upon them and show up the inadequacy of CRAs to promote the stability of credit markets.³²⁸ The reference to ratings in bilateral credit transactions purportedly makes it easier for the lender to estimate the creditworthiness of the borrower, and act accordingly. All this raises concerns about the usefulness of CRAs’ evaluations and their ability to provide accurate information about the credit quality of borrowers and, generally, to maintain market efficiency.³²⁹

However, as has been observed, ‘in modern credit markets, both debtors and creditors are embedded in complex networks of obligations, and so their solvency depends on multilateral interactions. Such systemic dependencies cannot be fully captured using a bilateral device, no matter how well-calibrated’.³³⁰

³²⁶ Milosz Gudowski, ‘Mortgage Credit Ratings and the Financial Crisis: The Need for a State-Run Mortgage Security Credit Rating Agency’ (2010) *Columbia Business Law Review* 1, 274-275.

³²⁷ John Patrick Hunt, ‘Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement’ (2009) *Columbia Business Law Review* 1, 138.

³²⁸ Tracy Alloway, ‘MBS deal shelved after rift over ratings’ *Financial Times* (London, 12 May 2014), where it is observed that ‘since the financial crisis, regulators have encouraged credit rating agencies to give “unsolicited” opinions on deals that they are not hired to evaluate, as part of an effort to avoid the ratings shopping that proliferated before 2008’. Further, it is noted that ‘rating agencies have also been keen to criticise each other’s opinions as they seek to fight the perception that they failed to properly evaluate the risks embedded in mortgage bonds before the crisis’.

³²⁹ Mark Carl Rom, ‘The Credit Rating Agencies and the Subprime Mess: Greedy, Ignorant, and Stressed?’ (2009) 69 *Public Administration Review* 4, 644-645.

³³⁰ Bruce G. Carruthers, ‘From uncertainty toward risk: the case of credit ratings’ (2013) 11 *Socio-Economic Review*, 545-546.

The rapid growth of CRAs' activities brought to light a controversial aspect of the corporate debt market: the use of 'rating triggers' in financial contracts. At first sight, a 'rating trigger' can be defined as a particular contractual clause included in private bond indentures that ensures a required credit rating threshold of the borrower's liquidity risk.³³¹

Generally, the use of rating triggers falls within the category of debt covenants on account of their role in monitoring the performance and creditworthiness of companies. As the SEC has stated, rating triggers are 'contractual provisions that terminate credit availability or accelerate credit obligations in the event of specified rating actions, with the result that a rating downgrade could lead to an escalating liquidity crisis for issuers subject to ratings triggers'.³³²

The function of rating triggers underlines the varying effects that they may have for credit rating agencies' assessments and, generally, for financial stability. The fairness of these contractual provisions has been called into question following the well-known scandals which occurred in the corporate sector (e.g. Enron, AIG and Pacific Gas and Electric Company).³³³

Such clauses were adopted by parties to verify the solvency of borrowers and to ensure the enforceability of the lender's claim in case of a downgrading of the borrower's rating. As Nicholls has observed 'the widespread use of credit ratings

³³¹ SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market' (January 2003) 30. See also Federico Parmeggiani, 'Rating Triggers, Market Risk and the Need for More Regulation' (2013) 14 *European Business Organization Law Review* 3, 428. The author provides an analysis of rating triggers by identifying some basic types of clauses: (1) 'rating-based collateral and bonding provisions', usually included in bank loan agreements 'they require the borrower either to post more collateral, or to provide a specific letter of credit, or to secure, in other ways, the claim of the lenders put at stake by the rating downgrade'; (2) 'rating step-up triggers' (or 'rating-based pricing grids'), 'when incorporated into bond indentures, they require the issuer to increase the interest paid to bondholders as its rating falls below the thresholds set in the contract'; (3) 'acceleration trigger' which requires that, 'in the event of the designated downgrade, the borrower has the duty to accelerate the payment of the loaned capital to the lender or the payment of the bond's principal to bondholders'; (4) 'rating-based put provision' which requires 'the borrower whose rating has been downgraded below the designated threshold to buy back the issued debt from the lenders'; and (5) 'rating-based default trigger' that 'allows the lender to regard the borrower's designated downgrade as an event of default on the obligation protected by the trigger, turning the increase in the counterparty risk into the failure of the latter to fulfil the obligation set in the contract'.

³³² SEC (note 331) 30. See also Karan Bhanot and Antonio S. Mello, 'Should corporate debt include a rating trigger?' (2006) 79 *Journal of Financial Economics* 1, 69-70.

³³³ SEC (note 331) 29. See also Diane Mage Roberts, 'Credit Rating Agencies: Is Additional Regulation Inevitable?' (2004) 19 *Journal of International Banking and Financial Law* 5, 178.

in private contracts has some causal connection to the enduring dominance of the largest CRAs and the potential for anti-competitive behaviour'.³³⁴

On the one hand, rating triggers guarantee access to securities by lowering the cost of capital. On the other hand, they keep the borrower aware of its ability to repay the debt on time and full. Rating triggers look at the risk of borrower's defaulting and at the capital structure of the firm and the value of the company's assets.³³⁵ In substance, the important function of rating triggers is to force borrowers to pursue low risk strategies and to monitor the company's liquidity risk.

The payment of a rating trigger materializes when the value of the firm's assets falls below a certain level. A closer examination of the aim of rating triggers in financial contracts suggests that parties intend to force borrowers to repay their debt through forms of negative pledge.³³⁶ This consideration comes from the objective of the 'rating trigger', essentially to maintain the equity and leverage firm value above a certain specified credit rating and to threaten borrowers when their credit risk is higher.³³⁷ Clearly, the adoption of these clauses is delegated to the freedom of parties in a contract, but the question is: is there a need for firms to incorporate rating triggers in their contractual arrangements?

As a first approximation, firms use rating triggers to minimize agency conflicts and asymmetric information problems between managers and debtholders.³³⁸ Another explanation can be found by considering the incorporation of triggers as a solution for the 'adverse selection' problem.³³⁹

³³⁴ Christopher C. Nicholls, 'Public and private uses of credit ratings' (August 2005) *Capital Markets Institute Policy Series*, 4.

³³⁵ Sérgio Silva and José Azevedo Pereira, 'Optimal Debt, Asset Substitution and Coupon Rating-Trigger Covenants' (2008) <www6.fe.uc.pt/pfn2008/UserFiles/pdf/776.pdf> accessed 13 November 2013, 25-26.

³³⁶ Negative pledge is generally referred to a covenant in a loan agreement, where the main purpose is to ensure that other creditors do not obtain a preferred claim over the assets of the debtor in the event of insolvency. See Lee C. Buchheit, 'Negative Pledge Clauses: The Games People Play' (1990) 9 *International Financial Law Review*, 10-11; Carl S. Bjerre, 'Secured Transactions Inside Out: Negative Pledge Covenants Property and Perfection' (1999) 84 *Cornell Law Review* 2, 307; Michael Bradfield and Nancy R. Jacklin, 'Problems Posed by Negative Pledge Covenants in International Loan Agreements' (1984) 23 *Columbia Journal of Transnational Law* 1, 133-135; Morey W. McDaniel, 'Are Negative Pledge Clauses in Public Debt Issues Obsolete?' (1983) 38 *The Business Lawyer* 3, 867-868.

³³⁷ Christian Koziol and Jochen Lawrenz, 'Optimal design of rating-trigger step-up bonds: Agency conflicts versus asymmetric information' (2010) 16 *Journal of Corporate Finance* 2, 182-183. The authors underline the agency conflicts and asymmetric information problems in using rating triggers contractual provisions.

³³⁸ S&P's, 'Evaluating Liquidity Triggers in Insurance Enterprises' (November 2008) 2-3.

³³⁹ Federico Parmeggiani (note 331) 441. The adverse selection problem can occur when potential

It can be assumed that the monitoring information displayed by rating triggers measures the value of the firm and takes a picture of the firm's position at a given moment in time. This means that rating triggers can be used as a 'speculative monitor' in order to evaluate the financial conditions of the firm, or most possibly to recommend or discourage investment in the firm to investors.³⁴⁰

On this view, rating triggers act as market signalling by conveying information about the creditworthiness of the firm.³⁴¹ This type of signalling helps to reduce informational asymmetries but if it is used to deteriorate the corporation's liquidity (for example by aggravating the liquidity stress of issuers) it may destabilise the debt market and harm investors.

Additionally, rating triggers may avoid the 'adverse selection' problem when the information provided reflects the actual risk profile of the firm.³⁴² In contrast, reckless endorsement of triggers may distort the information signalled to investors with the result that the assessment of CRAs is altered and the value of the company affected.³⁴³ Further, the credit rating agencies could incentivise the use of rating triggers in financial contracts in order to enhance the reputation of the issuer or to threaten the borrower's financial position.

As already indicated, rating triggers constitute particular debt covenants: they tailor loans in order to protect lenders and, at the same time, they constrain borrowers to maintain their own duty to reduce the liquidity risk. However, the use of rating triggers may vary in terms of the purposes of parties in financial

lenders find it difficult to assess the risk profile of the companies in the market.

³⁴⁰ Jean Tirole, *The Theory of Corporate Finance* (Princeton, New Jersey: Princeton University Press, 2006) 27-28. An analysis of the role of monitoring within the theory of firms is carried out by Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 4, 337-338.

³⁴¹ On the concept of 'market signalling' see the classical contribution of Michael Spence, *Market Signalling. Informational Transfer in Hiring and Related Screening Processes* (Cambridge MA: Harvard University Press, 1974).

³⁴² The 'adverse selection' effect occurs when one party in a transaction has better information than the other party. It materializes before the transaction occurs. Generally, the potential borrowers most likely to produce adverse outcomes are the ones most likely to seek a loan and be selected. The 'moral hazard' effect occurs when one party has an incentive to behave differently once an agreement is made between parties. The hazard is that the borrower has incentives to engage in undesirable (immoral) activities which make it more likely that it will not pay back the loan. For an analysis of the theory of 'moral hazard' and the theory of 'adverse selection', see the classic work of George A. Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 *The Quarterly Journal of Economics* 3, 493-494. See also Mark V. Pauly, 'Over insurance and Public Provision of Insurance: The Roles of Moral Hazard and Adverse Selection' (1974) 88 *The Quarterly Journal of Economics* 1, 54-55.

³⁴³ Keith J. Crocker and Arthur Snow, 'The social value of hidden information in adverse selection economies' (1992) 48 *Journal of Public Economics* 3, 317-318.

transactions. For instance, the ‘triggers’ can be used in merger operations—as a benchmark of the value of target companies—in order to attract investors and raise capital from the debt market.

After analysing the functions of rating triggers in financial transactions underlying the reasons for their use as debt covenants, the next section considers the main criticisms of the effects of such clauses on market participants by considering the question of the lack of disclosure of the triggers in contracts.

2.8 The main criticisms of rating triggers

Rating triggers may influence investment decisions but, most importantly, may deteriorate the financial outlook of firms (e.g., in the case of the collapse of Enron).³⁴⁴ Then, rating triggers may determine a ‘credit cliff’ effect whereby once a company’s rating drops below a certain level, it is then likely to undergo a precipitous drop. In substance, the use of rating triggers may directly impact on a firm’s cash flows and may reveal the behaviour of CRAs with respect to their clients.³⁴⁵

By exercising pressure on the borrower’s need for liquidity, rating triggers exacerbate the incentives to generate a demand for favourable ratings. For this reason, an unmonitored use of rating triggers could be transformed into unfair clauses for borrowers. Some of the most problematic controversial aspects have to do with the lack of disclosure of triggers in financial contracts: it can happen when the issuer does not want to display its creditworthiness to the market.³⁴⁶

Likewise, the issuer can arrange rating trigger provisions so as to force borrowers to drain liquidity and facilitate the access to capital (even if there is a

³⁴⁴ In particular, the Enron default was caused by the uncontrolled use of rating triggers that conferred on counterparties the right to demand cash collateral, and lenders the right to demand repayment of outstanding loans, once Enron’s credit rating lowered. See Moody’s, ‘The Unintended Consequences of Rating Triggers’ Moody’s Global Credit Research, Special Comment (December 2001). The report observes that ‘such triggers create the potential for a rapid decline in a company’s credit ratings and may even lead directly to a default or bankruptcy filing, which otherwise would not have occurred’.

³⁴⁵ Pepa Kraft, ‘The Impact of the Contractual Use of Ratings on the Rating Process - Evidence from Rating Agency Adjustments’ (2010) <<http://ssrn.com/abstract=1570776>> accessed 14 November 2013, 27-28. In particular, the author argues that ‘rating agencies provide more favourable adjustments to issuers with rating-based contracts relative to issuers with similar contracts based on accounting ratios and other issuers with private loan agreements’.

³⁴⁶ Monica M. Coppola and Pamela M. Stumpp, ‘Moody’s Analysis of US Corporate Rating Triggers Heightens Need for Increased Disclosure’, Special Comment, Moody’s Investors Service (July 2002) 1-2.

high probability of a downgrade). Another hypothesis of absence of disclosure exists where the firm uses rating triggers to give a positive signal of its financial performance (even if there is a high probability of default).

However, these effects can determine a phenomenon of ‘procyclicality’ whereby by adopting rating triggers—as ‘make-up instruments’—the firm may enter into liquidity stress and, consequently, fall into an insolvency spiral.³⁴⁷ Therefore, it is possible to argue that rating triggers are provisions developed to disclose a company’s creditworthiness: on the one hand they influence the performance of firms by signalling the liquidity of the corporation, on the other hand they measure the risk of default of the issuers by pressuring the company’s cost of debt.³⁴⁸

Clearly, the existence of rating triggers affects the CRAs’ assessment as to whether to downgrade a rating of an issuer’s debt. The CRAs’ knowledge of the existence of rating triggers in a rated issuer’s loan agreements inevitably has an impact on their decisions (for instance, CRAs can decline to issue a rating in order to gain the favour of firms). It has been claimed that ‘to the extent that CRAs are thought to be reluctant to downgrade issuers (...) such reticence would appear to be at odds with a view elsewhere expressed by CRA critics that the significant market power of the major CRAs allows them, in effect, to extract economic rents and provides temptations for market power abuse’.³⁴⁹

On this view, the use of rating triggers could represent an important benchmark for CRAs for evaluating the quality (and stability) of an issuer’s credit risk. As a result of the incorporation of such clauses in commercial and financial agreements, the relationship between issuers and rating agencies would suffer from inaccurate statements about the convenience to assess the ‘acquiescent company’.

The adoption of rating triggers could be fatal for companies with high default risk grade and could turn into a ‘boomerang’ if the loan structure is not adequately capitalized. In other words, these kinds of clauses are ‘time-bombs’ in a

³⁴⁷ Jeffery D. Amato and Craig H. Furfine, ‘Are credit ratings procyclical?’ (2004) 28 *Journal of Banking & Finance* 11, 2642-2643.

³⁴⁸ Moody’s Investor Services, ‘Special Comment: 2008 Rating Trigger Trends in the U.S. Life (Re)Insurance Industry’ (January 2009) 1-2; Moody’s Investor Services, ‘Rating Triggers in the Asset Management Industry 2008 Update’ (January 2009) 1, where it is pointed out that ‘Rating triggers represent a “passive” risk that could be rapidly activated (“triggered”) against a company by a rating downgrade’.

³⁴⁹ Christopher C. Nicholls (note 334) 18-19.

company's financial capacity because they exacerbate liquidity runs that can easily turn into insolvency.³⁵⁰

Furthermore, rating triggers could bring about instability in the securities market on the account of their negative effects.³⁵¹ For this reason, it is questioned whether rating triggers show the genuine creditworthiness of issuer and the candour of financial transactions, since the company can be astute enough to draw the money in case of imminent downgrading.

The use of rating triggers can reflect the CRAs' assessments with the result that they cause the 'death' of corporations.³⁵² Consequently, rating triggers used to forecast an issuer's default can hide negative biases and increase moral hazard as well as adverse selection effects. These outcomes may stimulate the investor's demand for weaker-quality debt and, plainly, result in credit deterioration.

In addition, the widespread use of rating triggers in private contracts could intensify the mechanistic reliance on credit ratings on the part of market participants instead of mitigating counterparty risk.³⁵³ From this point of view, the problem is the accuracy of a rating announcement (and the reliability of CRAs' assessment) that can be influenced by the need of issuer to raise capital in the market.

In the light of these considerations, rating triggers can be considered perilous clauses for the stability of financial markets on the account of their capacity to have a 'domino-effect' in the event of an unexpected downgrade followed by default.

After considering the controversial aspects of using rating triggers in financial agreements, the next section focuses on the systemic importance of CRAs and the implications of credit ratings in the sovereign debt structure.

³⁵⁰ Claire A. Hill, 'Regulating the Rating Agencies' (2004) 82 *Washington University Law Quarterly* 1, 68.

³⁵¹ Thomas Williams, 'Rating triggers: corporates worried as market sours' (2002) 21 *International Financial Law Review* 8, 4.

³⁵² Tim Reason, 'Not Trigger Happy. Credit-rating firms are taking a closer look at how corporate credit agreements employ rating triggers' *CFO Magazine*, 21 February 2002, where it is pointed out that 'such triggers—particularly those setting off accelerated debt repayment, or "puts" in backup credit lines when there's a downgrade—can rapidly push already shaky borrowers into bankruptcy'.

³⁵³ Aline Darbellay (note 289) 174-176. The authors argue that 'because of the presence of "rating triggers", leading CRAs may become more reluctant to downgrade and hence partly lose independent judgment' (at 176).

2.9 The impact of credit ratings on the EU sovereign debt crisis

The 2010-2012 EU debt crisis showed the significant role of sovereign ratings and the evident reliance of countries on bond financing.³⁵⁴ In this respect, the over-reliance on the main CRAs increased the systemic risk in the financial markets by raising alarm about States.³⁵⁵

In particular, statements by CRAs have given rise to criticism in the Eurozone on account of the surprising downgrades in the creditworthiness of some EU members in 2012-2013, namely Austria, France, the Netherlands and the UK that alarmed the sovereign debt market and affected the cost of funding.³⁵⁶ Between 1 January 2009 and 1 January 2014, CRAs downgraded countries such as Greece, Ireland, Italy, Portugal and Spain where the economic outlook had already been hit by the events of the 2007-2009 financial crisis.³⁵⁷

The powerful role of credit ratings influences not only private finances but also a country's finances, budget, economic policies and politics, and, in the case of the Eurozone, it can be claimed that credit ratings are shaping the whole EU structure and institutional development.³⁵⁸ As ESMA has stated, 'sovereign credit ratings play a crucial role from a credit market and financial stability perspective by informing investors about the quality of sovereign debt and the credit risk associated with holding government securities'.³⁵⁹

³⁵⁴ Francesco Capriglione, 'Financial Crisis and Sovereign Debt. The European Union Between Risks and Opportunities' (2012) 1 *Law and Economics Yearly Review* 1, 31-32.

³⁵⁵ Owain ap Gwilym and Rasha Alsakka 'Sovereign Rating Actions: Is the Criticism Justified?' (2011) 46 *Intereconomics Forum* 5, 248-253.

³⁵⁶ Sylvester C.W. Eijffinger, 'Rating Agencies: Role and Influence of Their Sovereign Credit Risk Assessment in the Eurozone' (2012) 50 *Journal of Common Market Studies* 6, 912. The author observes that 'a downgrade of a sovereign borrower, or even the announcement of a possible future downgrade, may jeopardize the achievements of implemented austerity measures'. See also Vivianne Rodrigues and Stephen Foley, 'UK loses triple A credit rating' *Financial Times* (London, 29 November 2013); Josh Noble and John Aglionby, 'S&P downgrades Netherlands' credit rating' *Financial Times* (London, 29 November 2013).

³⁵⁷ In particular, the markets started to mistrust the creditworthiness of these countries by exercising huge pressure on their debt. The sovereign debt crisis in the Euro area has revealed the relevance of credit ratings and in particular the fragility of the monetary and fiscal policy framework of the European Monetary Union. As a result, the 2010-2012 sovereign-debt crisis created much volatility in EU financial markets, causing large movements in bond yields and in the exchange rates for the Euro. See Norbert Gaillard, 'How and why credit rating agencies missed the Eurozone debt crisis' (2014) 9 *Capital Markets Law Journal* 2, 128.

³⁵⁸ Ramon Santacana and Javier Siles, 'Rating Agencies and the European Union Sovereign Debt Crisis: An Ethical Approach' (2013) 6 *Journal of International Business Ethics* 1-2, 27.

³⁵⁹ ESMA, 'Technical Advice. In accordance with Article 39(b) 2 of the CRA Regulation regarding the appropriateness of the development of a European creditworthiness assessment for sovereign debt', 17 July 2014, 5. It is observed that 'the crucial importance of sovereign ratings is amplified by the "cascade" effect, which can arise when rating actions regarding sovereigns indirectly influence the terms and extent of borrowing for other rated entities'.

In this context, the publication of sovereign ratings for EU countries generated high attention for CRAs' announcements with the result that they spread the risk of sovereign default among Member States.³⁶⁰ In academic writings, sovereign ratings are defined as 'assessments of the relative likelihood that a borrower will default on its obligations'.³⁶¹ It should be noted that rating announcements may create spillover effects in the securities markets because of sluggishness to downgrade the creditworthiness of sovereign debt.³⁶²

As has been observed, ratings provided an arbitrary evaluation of government bonds in the Euro area when the sovereign debt crisis erupted.³⁶³ In this respect, a leading CRA has been censured by ESMA for an erroneous downgrade alert when the EU securities authority found evident failures in managing market-sensitive data for assigning ratings to sovereign debt.³⁶⁴

One can argue that CRAs should regulate the flow of market-sensitive information and provide valuable risk assessments for investors. However, the leading CRAs act as 'raptor-capitalist businesses' by accumulating fees and their performance is poor.³⁶⁵

Sovereign ratings seem speculative instruments in the hands of CRAs rather than a useful benchmark of information about the obligations of central governments.³⁶⁶ However, the central aspect to be assessed is the passive role of

³⁶⁰ Manfred Gärtner, Björn Griesbach and Florian Jung, 'PIGS or Lambs? The European Sovereign Debt Crisis and the Role of Rating Agencies' (2011) 17 *International Advances in Economic Research* 3, 289.

³⁶¹ Richard Cantor and Frank Packer, 'Determinants and impact of sovereign credit ratings' (1996) 2 *Economic Policy Review* 2, 38. See also António Afonso, Pedro Gomes and Philipp Rother, 'Short and Long-run Determinants of Sovereign Debt Credit Ratings' (2011) 16 *International Journal of Finance & Economics* 1, 1. They put forward the following definition: 'sovereign credit ratings are a condensed assessment of a government's ability and willingness to repay its public debt on time, both in principal and in interest. In this, they are forward looking qualitative measures of the probability of default put forward by rating agencies'.

³⁶² Miguel A. Ferreira and Paulo M. Gama, 'Does sovereign debt ratings news spill over to international stock market?' (2007) 31 *Journal of Banking & Finance* 10, 3162. See also Rabah Arezki, Bertrand Candelon and Amadou N. R. Sy, 'Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis', IMF Working Paper No 11/68, 4-5.

³⁶³ Manfred Gärtner, Björn Griesbach and Florian Jung (note 360) 291.

³⁶⁴ Sam Fleming and Hugh Carnegie, 'S&P censured for erroneous France downgrade alert' *Financial Times* (London, 3 June 2014). The ESMA investigation found that S&P was responsible for wrongly announcing in 2011 that France's credit rating had been downgraded. S&P's error revealed a lack of effective oversight and an absence of sound internal control mechanisms. As a result, S&P's error caused a deterioration in France's public finances and the loss of its triple-A status.

³⁶⁵ Glen Newey, 'Who rates the rating agencies?' *London Review of Books Blog* (London 12 November 2013).

³⁶⁶ Henrik Gildehaus, 'The rating agency oligopoly and its consequences for European competition law' (2012) 37 *European Law Review* 3, 270, in which it is pointed out that 'nonetheless, CRAs

States when it comes to the consistency and rationale of sovereign ratings. It is paradoxical that simple opinions may destabilize the economic policies and jeopardize the financial trends of sovereign States.³⁶⁷

Sovereign credit risk assessments may have a huge impact on the ratings assigned to domestic banks or companies (by determining the capacity to repay the debt) because ‘they involve an exercise of private decision-making power which has the potential both to undermine the State and to ‘topple’ it’.³⁶⁸ For this reason they may constitute harmful statements for the international financial markets.³⁶⁹

Among scholars and policymakers there is scepticism about the genuine intention of sovereign ratings having regard to aggressive, i.e. speculative, announcements about European debt and EU-IMF bailout plans.³⁷⁰ The sovereign ratings have become the key determinant in the financial assistance programmes for the Eurozone (European Stability Mechanism³⁷¹, European Financial Stabilisation Mechanism³⁷² and European Financial Stability Facility³⁷³) and an

seem to be indispensable for the functioning of our highly sophisticated financial markets—with ratings sometimes even amounting to a wake-up call, as seen with Greece, the United States and others’.

³⁶⁷ Ralph Atkins and Jamie Smyth, ‘Ireland’s comeback story runs into growth test’ *Financial Times* (London, 19 November 2013). The authors commented on Moody’s changed outlook for Ireland (from ‘negative’ to ‘stable’) by quoting a rating agency’s lead analyst who observed that ‘an eventual upgrade depends, however, on Ireland’s economic fortunes’. This consideration shows how ratings announcements could influence the domestic debt markets (and have direct effects on internal fiscal policies).

³⁶⁸ Harry McVea, ‘Written evidence on Credit Rating Agencies’ House of Commons Treasury Committee, February 2012, 3.

³⁶⁹ Rasha Alsakka and Owain ap Gwilym, ‘Leads and lags in sovereign credit ratings’ (2010) 34 *Journal of Banking & Finance* 11, 2625. The authors draw attention to the phenomenon of ‘sovereign rating migrations’ in which rating changes by one agency have an economically and statistically significant influence on the probability of rating actions by other agencies.

³⁷⁰ Christopher Alessi, Roya Wolverson and Mohammed Aly Sergie, ‘The Credit Rating Controversy’ (22 October 2013) US Council of Foreign Relations, <<http://www.cfr.org/united-states/credit-rating-controversy/p22328>> accessed 25 November 2013.

³⁷¹ The European Stability Mechanism (ESM) is an intergovernmental institution established under public international law, based in Luxembourg by a treaty signed by the Euro area countries. The ESM is the permanent crisis resolution mechanism, which has been set up to provide financial assistance, subject to strict conditionality, to Euro area countries experiencing severe financing difficulties. See Rodrigo Olivares-Caminal, ‘The EU Architecture to Avert a Sovereign Debt Crisis’ (2011) *OECD Journal: Financial Markets Trend* 2, 13-15.

³⁷² The European Financial Stabilisation Mechanism (EFSM) provides financial assistance to EU Member States in financial difficulties. It is a special purpose vehicle established as a ‘société anonyme’ incorporated under Luxembourg law. The EFSM is based on the assistance clause in Article 122(2) of Treaty on the Functioning of the European Union. The EU Commission is empowered to contract borrowings on behalf of the Union for the purpose of funding loans made under the EFSM according to Article 2 of Council Regulation No 407/2010 of 11 May 2010 establishing a European financial stabilization mechanism (OJ 2010 L 118, p. 1). See Rodrigo Olivares-Caminal (note 371) 5-6.

important benchmark of the fiscal policy framework in the European Monetary Union.³⁷⁴

For example, in the Greek crisis the ratings performed by the leading CRAs brought about a significant increase in interest rates and, as a consequence, had a negative impact on the securities market.³⁷⁵ The above considerations led to a first preliminary conclusion: ratings announcements have a significant impact on States' economies because of the huge reliance on CRAs.³⁷⁶ This happens when market participants are dependent on only one source of information and place their confidence chiefly in the warnings of sovereign ratings.³⁷⁷

It can be observed that sovereign ratings changed from providing a judgement about the capacity and willingness of governments to raise the necessary resources for the timely servicing of their debt obligations, into an evaluation of their management of fiscal and budgetary conducts.³⁷⁸ However, the sovereign ratings should help governments to convey CRAs' information into stable policy

³⁷³ The European Financial Stability Facility (EFSF) was created by the EU Member States in order to safeguard financial stability in Eurozone and to provide financial assistance to Member States within the framework of a macro-economic adjustment programme. The EFSF issues bonds or other debt instruments on the capital markets and may intervene in the primary and secondary bond markets, act on the basis of a precautionary programme and finance recapitalisations of financial institutions through loans to governments. See Rodrigo Olivares-Caminal (note 371) 7-9.

³⁷⁴ Adrian Blundell-Wignall, 'Solving the Financial and Sovereign Debt Crisis in Europe' (2011) 29 *OECD Journal: Financial Market Trends* 2, 9-10. By contrast see the considerations of House of Lords – European Union Committee, 'Sovereign Credit Ratings: Shooting the Messenger?', 21st Report of Session 2010-12, 21 July 2011, 20-21.

³⁷⁵ Sovereign credit signals had a great impact in the case of Greece on account of the reliance placed on them by the financial markets and the foreign exchange market. The fact that ratings news induces a market reaction demonstrates the systemic relevance of CRAs and the over-reliance of financial actors on ratings. Recently, the CRAs upgraded the credit outlook for Spain, boosting new confidence among analysts and investors in the Spanish economy. In particular, S&P stated 'we see improvement in Spain's external position as economic growth gradually resumes'; clearly this announcement determined a positive signal for sovereign debt markets and marked a shift in financial market sentiment. However, the question is: to what extent can sovereign ratings influence the economic policies of national states? The answer is not difficult to find so long as governments continue to rely solely on the credit rating agencies' prophecies. See Tobias Buck, 'S&P upgrades credit outlook for Spain' *Financial Times* (London 29 November 2013).

³⁷⁶ The criticism of CRAs during the European sovereign debt crisis was more focused on the extent and timing of downgrades. See Rasha Alsakka and Owain ap Gwilym, 'Rating agencies' signals during the European sovereign debt crisis: Market impact and spillovers' (2013) 85 *Journal of Economic Behavior & Organization*, 145.

³⁷⁷ Gwion Williams, Rasha Alsakka and Owain ap Gwilym, 'The impact of sovereign rating actions on bank ratings in emerging markets' (2013) 37 *Journal of Banking & Finance* 2, 565, observe that 'sovereign ratings represent assessments of the ability and willingness of governments to meet their financial obligations'.

³⁷⁸ Gunther Tichy, 'Did Rating Agencies Boost the Financial Crisis?' (2011) 46 *Intereconomics Forum* 5, 245.

decisions. In essence, rating agencies have evolved from being watchdogs of financial markets to guardians of fiscal discipline.³⁷⁹

After providing a critical view of sovereign ratings by stressing their role in the 2010-2012 EU debt crisis, the next section considers regulatory intervention with regard to sovereign ratings activities by taking into account the main reforms adopted at the EU and US level for addressing the shortcomings of the sovereign ratings process.

2.10 *The regulatory intervention on sovereign ratings activities*

The shortcomings of sovereign ratings triggered the intervention of regulators at the EU level and in the US in order to address the gaps in existing legislation. In particular, the enacted provisions attempt to enhance transparency in the preparation of sovereign ratings, strengthen the review of those ratings and increase the quality of information used to assess the creditworthiness of States.³⁸⁰

In this regard, the regulatory reforms intend to replace the CRAs' *ad hoc* ratings by marking credit according to bond yield spreads, rather than the converse.³⁸¹ In so far as over-reliance on credit ratings is the main target of criticisms, financial institutions and States should develop their own credit risk assessment in order to reduce the mechanistic influence of CRAs.³⁸²

At EU level, Regulation No 462/2013³⁸³ introduced significant obligations for sovereign ratings in order to address the huge role they came to play during the Euro debt crisis. According to recital 45 in the preamble to the 2013 CRA Regulation, 'when publishing their sovereign ratings, credit rating agencies should explain in their press releases or reports the key elements underlying those credit

³⁷⁹ Marek Hanusch and Paul M. Vaaler, 'Credit Rating Agencies in Emerging Democracies. Guardians of Fiscal Discipline?' (2013) The World Bank, Policy Research Working Paper No 6379, 8, where the authors argue that 'CRAs play a positive role in emerging democracies around the world as private guardians of public fiscal discipline'.

³⁸⁰ It is generally considered that rating announcements often provide information that the market has already taken into account, causing alarm among market participants and exacerbating reliance on credit ratings.

³⁸¹ Bartholomew Paudyn, 'Credit rating agencies and the sovereign debt crisis: Performing the politics of creditworthiness through risk and uncertainty' (2013) 20 *Review of International Political Economy* 4, 793-794.

³⁸² Gillian Tett, 'Beware the consequences of reassessing sovereign risk' *Financial Times* (London 4 November 2011).

³⁸³ Regulation (EU) No 462/2013.

ratings’ and, most importantly, ‘credit rating agencies should refrain from any direct or explicit policy recommendations on policies of sovereign entities’.

Although these provisions aim to reduce the risk of inaccurate assessments by imposing certain restrictions, CRAs are not forced to verify the correctness of their data and the appropriateness of their announcements.³⁸⁴ As a result, the demand for sovereign credit ratings (in particular, foreign currency ratings) remains prevalent and relevant in the international bond markets.³⁸⁵

Article 8a(2) of the 2013 CRA Regulation improves the quality of ratings of sovereign debt of EU Member States by providing that CRAs cannot issue any rating outlooks ‘without the consent of the rated entity, unless [the relevant information] is available from generally accessible sources’.³⁸⁶ Also, Article 8a(3) of the 2013 CRA Regulation requires CRAs to set a calendar indicating when they will rate Member States, limited to three dates per year for unsolicited sovereign ratings.³⁸⁷

This rule focuses on transparency by providing that sovereign ratings should take into consideration the individual country reports and be made publicly available. In addition, the above rule states that potential changes in sovereign outlook should not be based on information provided by the rated entity without its consent and the publication of those ratings should take place only at the end of business of the trading venues and at least one hour before their opening.

At first glance, this rule is designed to mitigate the risk of volatility of government debt that may harm the financial stability of the Eurozone and the economic policies of Member States in distress. However, the EU legislator

³⁸⁴ On 18 July 2014, ESMA published ‘Technical advice to the European Commission on the development of an EU creditworthiness assessment for sovereign debt’. In this report, ESMA underlined the need to ensure that (1) the rating process should be fully independent; (2) the review function responsible for the annual review of rating methodologies must be independent of the business lines which are responsible for credit rating agencies; (3) the access to pre-rating information should only be available to people involved in rating activities and all necessary steps should be taken to ensure this information is adequately protected; and (4) the sufficient resources should be available for the conduct of both a rigorous rating process as well as ongoing monitoring.

³⁸⁵ The activities of CRAs with regard to sovereign credit risk assessments have been strongly questioned for their bad timing and for the fact that they lagged behind markets in their judgement. This means that CRAs provide a measure of risk rather than prognosis of the probability of default. See on this view Nicolas Véron and Guntram B. Wolff, ‘Rating Agencies and Sovereign Credit Risk Assessment’ in European Parliament, Directorate General for Internal Policies, *Rating Agencies - Role and Influence of their Sovereign Credit Risk Assessment in the Euro Area*, Monetary Dialogue December 2011, December 2011, 64.

³⁸⁶ Article 8a(2) of Regulation (EU) No 462/2013.

³⁸⁷ Article 8a(3) of Regulation (EU) No 462/2013.

missed the opportunity to reduce the powerful influence of CRAs by banning unsolicited sovereign ratings for EU Member States. It seems that the legislator adopted a ‘light touch approach’ instead of enacting strict rules to act as a constraint on rating agencies’ watch statements. The EU Regulation does not address the possibility of holding CRAs accountable for the consequences of their outlooks on sovereign bonds.³⁸⁸

ESMA issued a report in which rating agencies were accused of exacerbating the sovereign debt crisis by publishing debt-rating downgrades of periphery and core EU States.³⁸⁹ In particular, ESMA revealed shortcomings in CRAs’ controls and resources and found deficiencies in the way that they manage the highly market-sensitive task of assigning ratings to government debt.³⁹⁰ The ESMA report can be considered a first attempt to restore the transparency of sovereign assessments and to address the weaknesses in the sovereign ratings process.

Admittedly, the assessment of likelihood of government default is a challenging task for CRAs basically because sovereign debt contracts cannot be enforced by a third party and it is complicated to predict the willingness to pay in sovereign borrowing.³⁹¹

In point of fact, the sovereign entity cannot be dissolved, a forced liquidation of its assets is impossible, and its creditors cannot assume ownership.³⁹² This implies that the instruments to deal with sovereign-debt crises in an orderly way are limited. In the case of private debt, the ultimate solution remains liquidating the borrower’s assets and, in the case of corporations, dissolving the organisation. In the case of sovereign debt, a procedure should be found to restructure the debt

³⁸⁸ For an academic commentary see Anil K Kashyap and Natalia Kovrijnykh, ‘Who Should Pay for Credit Ratings and How?’ (2013) National Bureau of Economic Research Working Paper No 18923.

³⁸⁹ ESMA, ‘Credit Rating Agencies. Sovereign Ratings Investigation’, 2 December 2013, 3.

³⁹⁰ Sam Fleming, ‘Rating agencies face fines threat after EU sovereign debt probe’ *Financial Times* (London, 2 December 2013).

³⁹¹ Rawi Abdelal, *Capital Rules. The Construction of Global Finance* (Cambridge MA: Harvard University Press 2007) 162-163.

³⁹² Lee C. Buchheit and G. Mitu Gulati, ‘Responsible Sovereign Lending and Borrowing’, UNCTAD Discussion Papers No 198, April 2010, 1. The authors argue that ‘the word sovereign connotes an entity that is not subject to external constraints, least of all the tiresome constraint of repaying borrowed money. Yet sovereigns borrow money all of the time and they pay it back most of the time’.

in an orderly fashion through negotiations with the creditors given that it is impossible to liquidate the debtor.³⁹³

In the US, the Dodd-Frank Act recognizes the systemic importance of credit ratings and the reliance placed on CRAs activities as matters of national public interest.³⁹⁴ In particular, the Dodd-Frank Act imposes new rules with respect to CRAs' public disclosure and, generally, to over-reliance on the credit ratings industry (by removing statutory references to credit ratings).³⁹⁵

Section 931(5) of the Dodd-Frank Act states that the inaccuracy of credit ratings on the structured finance market 'contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States'.³⁹⁶

Closer examination of the text suggests that, on the one hand, the Act does not provide any specific provisions on the regulation of sovereign ratings. On the other hand, it leaves the function of monitoring these ratings completely to the SEC. However, a more explicit reference to the accountability of sovereign ratings and to the disclosure of their methodologies' criteria would have been desirable.

It seems clear that the reforms implemented in the US securities markets do not attach great importance to the CRAs' government credit risk assessment owing to the fact that the latter had less impact on US public debt during the 2007-2009 financial crisis.³⁹⁷

³⁹³ Sovereign debt remains difficult to enforce because creditors' ability to collect is limited by the fact that only assets located outside the sovereigns' borders can be legally attached and countries tend to hold most of their assets within their borders. These elements imply that the instruments to deal with sovereign-debt crises in an orderly way are more limited than in the case of private debt, where the ultimate solution remains liquidating the borrower's assets and, in the case of corporations, dissolving the organisation. See Rodrigo Olivares-Caminal, 'Statutory Sovereign Debt Resolution Mechanisms' in Rosa M. Lastra and Lee Bucheit (eds), *Sovereign Debt Management* (Oxford: OUP 2014) 333-335; Rodrigo Olivares-Caminal, 'Litigation Aspects of Sovereign Debt' in Rodrigo Olivares-Caminal, John Douglas, Randall Guynn, Alan Kornberg, Sarah Paterson, Dalvinder Singh and Hilary Stonefrost (eds), *Debt Restructuring* (Oxford: OUP 2011) 389-391.

³⁹⁴ Section 931(1), Title IX, Subtitle C of the Dodd-Frank Act "Improvements to the Regulation of Credit Rating Agencies".

³⁹⁵ Section 939, Title IX, Subtitle C of the Dodd-Frank Act "Removal of statutory references to credit ratings".

³⁹⁶ Section 931(4) of the Dodd-Frank Act states that 'in certain activities, particularly in advising arrangers of structured financial products on potential ratings of such products, credit rating agencies face conflicts of interest that need to be carefully monitored and that therefore should be addressed explicitly in legislation in order to give clearer authority to the Securities and Exchange Commission'.

³⁹⁷ S&P's, 'Special Report on the U.S. Rating Downgrade and its Global Effects' (2011) 31 *Credit*

With these considerations in mind, it possible to argue that sovereign ratings play a useful role in fostering the stability and efficiency of the worldwide sovereign debt market. However, their use may have a dangerous influence on fragile economic policies—exacerbating the risk of volatility and facilitating the ‘alarm effect’—that may turn into speculative attacks on the securities markets.³⁹⁸

After considering the regulatory reforms on sovereign ratings activities introduced in the EU and US legislation and the main steps adopted for implementing the quality, independence, and transparency of the sovereign ratings process, the next section investigates the phenomenon of over-reliance on ratings and ventures proposals to make CRAs responsible for misrepresentation or detrimental reliance.

2.11 *Over-reliance on CRA ratings*

A primary source of over-reliance may be a misperception of what ratings represent. The observation that ‘the finance industry is grappling with the detrimental effects of the ratings regulation it already has’³⁹⁹ has to be seen in this context.

Excessive reliance on inaccurate credit ratings of financial products (particularly structured finance instruments) has facilitated the spread of the recent financial turmoil. More specifically, the regulatory use of credit ratings increasingly depends on government acceptance rather than on the extent to which they provide real value to market participants. This means that ‘market discipline increasingly is being replaced by government discipline’.⁴⁰⁰

Week 31, 18-19. See also *The Economist*, ‘Wakey, wakey. Standard & Poor’s may not have said anything new. That’s no reason for American politicians to ignore it’, 20 April 2011.

³⁹⁸ Joshua Aizenman, Mahir Binici and Michael M. Hutchison, ‘Credit Ratings and the Pricing of Sovereign Debt during the Euro Crisis’ (2013) National Bureau of Economic Research Working Paper No 19125, 2-3.

³⁹⁹ Harold Furchtgott-Roth, Robert W. Hahn and Anne Layne-Farrar, ‘The law and economics of regulating ratings firms’ (2007) 3 *Journal of Competition Law & Economics* 1, 77-79. It is argued that in credit and bond ratings there is a clear market failure such as limited access to information or externalities; and the proposed legislative solution for bond ratings may not go far enough in removing previous regulatory failures, but would at least be a step in the right direction (at 92).

⁴⁰⁰ Philippe Bergevin, ‘Addicted to Ratings: The Case for Reducing Governments’ Reliance on Credit Ratings’ (2010) C.D. Howe Institute Backgrounder Issue No 130 <<http://ssrn.com/abstract=1657881>> accessed 22 May 2012, 1.

An example of government reliance on CRAs can be found in the ‘Talf Initiative’—the US Term Asset-Backed Securities Loan Facility program⁴⁰¹—in which rating agencies play the role of arbiters in determining eligible assets. Under the Talf Initiative, ‘regulators have given the rating agencies (...) the authority to determine to which category a particular bond belongs, by whatever method they see fit’.⁴⁰²

Government use of CRAs has increased the practice of relying blindly on credit ratings’ internal models to assess credit risks. One scholar has noted that if credit ratings’ value rested only on their unique informational input and the reliability of this information, the failure of CRAs to provide accurate, up-to-date ratings would be sanctioned by market forces, acting on reputational incentives’.⁴⁰³ However, this is not the case because regulators have empowered CRAs by making it a requirement in many cases to securities transactions. The lower transparency and greater complexity in the securities markets ensured a heavy reliance by financial participants on rating agencies.⁴⁰⁴

Governmental intrusion in rating activities could exacerbate excessive reliance on ratings particularly in cases where market participants can believe that these carry a governmental ‘seal of approval’. Many investors did rely on these ratings and considered them not only to be expert opinions but authorized seals of approval. The problem that regulatory intervention runs the risk of exacerbating excessive reliance on ratings seems evident—particularly because of the high incentives for investors to rely uncritically on ratings as a substitute for independent evaluation.⁴⁰⁵ Regulatory reliance on CRAs transformed these ‘media

⁴⁰¹ On 25 November 2008, the Federal Reserve Board launched a credit facility programme (‘Talf initiative’). The ‘Talf’ was intended to assist the credit markets in accommodating the credit needs of consumers and small businesses by facilitating the issuance of asset-backed securities (ABS) and improving the market conditions for ABS more generally.

⁴⁰² Arturo Cifuentes, ‘Insight: Time we rated the bond graders’ *Financial Times* (London, 27 July 2009).

⁴⁰³ Amélie Champsaur, ‘The regulation of credit rating agencies in the US and the EU: recent initiatives and proposals’ (May 2005) Harvard Law School, Seminar in International Finance, LL.M. Paper, 30. It is explained that ‘in view of the discrepancy between reliance and reliability (what credit ratings are and what they should be or what the marketplace expect them to be) and the dangers of reliance *per se*, two concurring policy options would seem to make sense: increasing reliability of and decreasing reliance on credit ratings’ (at 35).

⁴⁰⁴ Jonathan Katz, Emanuel Salinas and Constantinos Stephanou, ‘Credit Rating Agencies’ (October 2009) The World Bank Group Note No 8, 3.

⁴⁰⁵ Sarah Pei Woo, ‘Stress before Consumption: A Proposal to Reform Agency Ratings’ (2012) 18 *European Law Journal* 1, 77. The author observes that ‘it is difficult to reduce reliance on ratings by market participants generally, as references to ratings and ratings triggers pervade investment

opinions' into a sort of official approval for companies needing access to the capital markets.

The Basel Committee argues that a key concern in the financial crisis was the fact that market participants relied excessively on external ratings instead of conducting the necessary due diligence in order to understand the risks underlying the rated instrument.⁴⁰⁶ In this light, Basel II explicitly allowed banking regulators to permit banks to use credit ratings from approved CRAs in calculating their net capital reserve requirements.

Reliance on external ratings could undermine incentives to conduct independent internal assessments of the credit quality of exposures. Such reliance on the ratings of the main rating firms—crystallised by the SEC and NRSROs—raises barriers to entry and discourages innovation in the provision of bond creditworthiness information.

The powerful effect of the regulators' reliance on the judgements of CRAs is shown by the importance of their pronouncements in bond markets.⁴⁰⁷ It is worth considering that eliminating the regulatory dependence on credit ratings may be the best way to foster a competitive environment for the credit rating industry.⁴⁰⁸ Regulators should simply stimulate investors not to use the same ratings and analysis.

An issuer may demand a rating because investors need the rating to fulfil regulatory or other requirements, even if neither party believes that the rating is a high quality assessment of creditworthiness. In this respect, overdependence on ratings was a central component of the credit crisis.⁴⁰⁹ It is considered, however, that this shifts the emphasis away from the major failures of the credit ratings agencies in terms of the lax and opaque way they addressed the information asymmetries and conflicts of interests as between issuers and investors.

guidelines, swap documentation, loan agreements, collateral triggers, and other important counterparty documents' (at 78).

⁴⁰⁶ BCBS, 'Strengthening the Resilience of the Banking Sector' (2009) Consultative Document <<http://www.bis.org/publ/bcbs164.htm>> accessed 24 May 2012, 55.

⁴⁰⁷ Lawrence J. White, 'The Credit Rating Agencies' (2010) 24 *Journal of Economic Perspectives* 2, 214.

⁴⁰⁸ Rolf H. Weber and Aline Darbellay, 'The regulatory use of credit ratings in bank capital requirement regulations' (2008) 10 *Journal of Banking Regulation* 1, 10.

⁴⁰⁹ Frank Partnoy, 'Overdependence on Credit Ratings was a Primary Cause of the Crisis' (2009) University of San Diego School of Law, Legal Studies Research Paper Series No 09-015, 17.

Further, these failures need to be seen in terms of ‘reputational value’ on financial markets, particularly when the misrepresentations in signalling default risks are taken into account. This emerged in previous corporate scandals such as Enron, Arthur Andersen, etc., the subprime defaults and most recently in connection with the EU sovereign debt crisis. A way to impose a restriction on rating agencies’ reliance is to expose them to liability for careless services.

From a regulatory perspective, the FSB published a set of ‘Principles for Reducing Reliance on CRA Ratings’.⁴¹⁰ This report applies the principles not only to the regulatory use of ratings, but also to a wider range of financial market activities and market participants—including central bank operations, investment mandates and private sector margin agreements.

As stated by the FSB, ‘the CRA ratings in standards and regulations contribute significantly to market reliance on ratings. This is a cause of the ‘cliff effects’ during the recent financial crisis, through which CRA rating downgrades can amplify procyclicality and cause systemic disruptions’.⁴¹¹ In this respect, the phenomenon of ‘cliff effects’ is determined ‘when regulatory capital and investment portfolios are adjusted in response to rating downgrades’.⁴¹²

The FSB’s principles aim to reduce ‘mechanistic’ reliance on CRA ratings and establish stronger internal credit risk assessment practices instead. Specifically, the reliance on CRA ratings should be reduced in ‘standards, laws and regulations’ and in markets more generally.⁴¹³ The FSB issued a report entitled ‘Thematic Review on FSB Principles for Reducing Reliance on CRA Ratings’ where it is recommended that the key challenge to reduce reliance on CRA ratings is to develop alternative standards of creditworthiness and processes so that CRA ratings are no more than an input to credit risk assessment.⁴¹⁴ In particular, the report underlines that ‘the FSB Principles do not imply that market participants

⁴¹⁰ FSB, ‘Principles for Reducing Reliance on CRA Ratings’, 27 October 2010.

⁴¹¹ *ibid* 1.

⁴¹² Iain MacNeil, ‘Credit rating agencies: regulation and financial stability’ in Thomas Cottier, Rosa M. Lastra and Christian Tietje (eds), *The Rule of Law in Monetary Affairs* (Cambridge: CUP 2014) 178.

⁴¹³ Pragyan Deb, Mark Manning, Gareth Murphy, Adrian Penalver and Aron Toth, ‘Whither the credit ratings industry?’ (March 2011) Bank of England, Financial Stability Paper No 9, 13-14. The authors observe that ‘any efforts to reduce reliance on CRA ratings should be supported by adequate transparency of issuer information, so as to permit private credit assessment by a wider range of market participants’ (at 17).

⁴¹⁴ FSB, ‘Thematic Review on FSB Principles for Reducing Reliance on CRA Ratings. Peer Review Report’, 12 May 2014, 5.

should avoid all use of CRA ratings, but that the use of CRA ratings is combined with exercise of their own judgement on creditworthiness'.⁴¹⁵

In this context, the UK Treasury Committee Report pointed out that 'one possible way to decrease over-reliance is to increase investors' knowledge about credit ratings'.⁴¹⁶ Particularly, the Committee suggests that more information about the scope of ratings, how they are formulated and what information they use may better equip individuals to make their own judgments about the quality of a rating.

At the European level, Regulation (EU) No 462/2013 introduced detailed rules in order to: (1) reduce financial institutions' over-reliance on credit ratings⁴¹⁷; (2) reduce European Supervisory Authorities' and the European Systemic Risk Board's over-reliance on credit ratings⁴¹⁸; and (3) reduce Union law's over-reliance on credit ratings.⁴¹⁹ These rules aim to reduce over-reliance on credit ratings by requiring financial institutions to strengthen their own credit risk assessment and not to rely 'solely and mechanistically' on external credit ratings.⁴²⁰

In this context, the Commission published the Paper 'EU Response to the Financial Stability Board (FSB) – EU Action Plan to reduce reliance on Credit

⁴¹⁵ *ibid* 10.

⁴¹⁶ House of Commons Treasury Committee (note 239) 73. In a similar vein, see Nicolas Véron, 'Rating Agencies: An Information Privilege Whose Time Has Passed' (2009) Bruegel Policy Contribution 2009/01, Briefing Paper for the European Parliament's ECON Committee, 6.

⁴¹⁷ Article 5a of Regulation (EU) No 462/2013 where it is stated that credit institutions, investment firms and insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties 'shall make their own credit risk assessment and shall not solely or mechanistically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument'.

⁴¹⁸ Article 5b of Regulation (EU) No 462/2013 where it is provided that the European Supervisory Authorities (European Securities and Markets Authority, European Banking Authority and European Insurance and Occupational Pensions Authority) 'shall not refer to credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger sole or mechanistic reliance on credit ratings by the competent authorities, the sectoral competent authorities, the entities referred to in the first subparagraph of Article 4(1) or other financial market participants'.

⁴¹⁹ Article 5c of Regulation (EU) No 462/2013 where it is stated that 'without prejudice to its right of initiative, the Commission shall continue to review whether references to credit ratings in Union law trigger or have the potential to trigger sole or mechanistic reliance on credit ratings by the competent authorities, the sectoral competent authorities, the entities referred to in the first subparagraph of Article 4(1) or other financial market participants with a view to deleting all references to credit ratings in Union law for regulatory purposes by 1 January 2020, provided that appropriate alternatives to credit risk assessment have been identified and implemented'.

⁴²⁰ Article 5c of Regulation (EU) No 462/2013 provides, *inter alia*, for the removal of any reference to credit ratings for regulatory purposes by 1 January 2020.

Rating Agency (CRA) Ratings'⁴²¹, which adopts a multi-layer approach involving EU regulation on credit rating agencies, sectoral legislation in financial services, and actions by European Supervisory Authorities (ESMA, EBA and EIOPA) and by national competent authorities.

In the US, the Dodd-Frank Act has increased accountability for CRAs while attempting to improve SEC oversight and make it easier for investors to sue rating agencies in private litigation.⁴²² The Act reduces over-reliance on credit ratings but it does not eliminate regulatory uses of credit ratings. It has been noted that 'the SEC and federal regulators, as well as state and local lawmakers, have the ratings embedded in many of their rules—effectively requiring investors to trust the ratings'.⁴²³

Consequently, reliance always involves some risk to the relying party. The reliance measure puts the injured party in as good a position as if the contract had never been made. Reliance in ratings decisions may turn out to be a wise decision, if nothing goes wrong and the transaction is executed, but it will turn out to be unwise if something prevents the deal from going through.⁴²⁴ Similarly, reliance on a CRA's evaluation will bind the CRA only if the evaluation is one for which the CRA should induce reliance on the part of the issuer.⁴²⁵

In this context, the US case law seems more inclined to treat the issuer's reliance as binding if its reliance appeared to increase the expected value of the transaction, so that even the CRA would have wanted to be committed.⁴²⁶ A court could reject expectation damages unless it can estimate them with reasonable accuracy. This will be the case where there is insufficient evidence or where the expectation damages are too indefinite to provide an estimate of how much loss the claimant has suffered. In assessing damages, 'courts should balance deterrence

⁴²¹ European Commission, Directorate General Internal Market and Services, 'EU Response to the Financial Stability Board (FSB) – EU Action Plan to reduce reliance on Credit Rating Agency (CRA) Ratings', Staff Working Paper, 16 May 2014, 4.

⁴²² Stephen Harper, 'Credit Rating Agencies Deserve Credit for the 2007-2008 Financial Crisis: An Analysis of CRA Liability Following the Enactment of the Dodd-Frank Act' (2011) 68 *Washington and Lee Law Review* 4, 1951.

⁴²³ Sarah Johnson, 'SEC Relies on Rating Agencies, Too' (14 February 2008) <<http://www.CFO.com>> accessed 27 March 2012.

⁴²⁴ *ibid* 502.

⁴²⁵ *ibid* 532.

⁴²⁶ *Drennan v Star Paving Co.*, 51 Cal.2d 409, 333 P.2d 757 Supreme Court of California, [1958]. See also *Hoffman v Red Owl Stores Inc.*, 133 N.W.2d 267 (Wis. 1965).

factors against the financial burden imposed on CRAs and the risk of market failure in the market for CRA services'.⁴²⁷

It can be claimed that the market's reliance on a small number of CRAs presents a difficult policy problem. In these terms, it seems better to increase the disclosure process and transparency in the ratings activities. In this context, in Europe a positive response has been provided by the regulatory framework established at the EU level.

After providing an analysis of the major problems of over-reliance on credit ratings, the next section considers the question of wrong incentives in the CRA market.

2.12 The question of wrong incentives in the CRA market

CRAs depend to a large extent on the 'issuer-pays' business model, i.e. on revenues provided by their clients. Such dependence constitutes a wrong incentive for CRAs. To explain the expansion of this business relationship, there are, on the one hand, the interests of issuers in obtaining high ratings (in order to lower the cost of capital and render marketable debt instruments) and, on the other, the interests of CRAs to accumulate reputational capital in the financial markets.

If CRAs provide a public good to the financial market (ratings), investors should be considered 'free-riders' in respect of that information, so that the wrong incentive springs in principle from the intention of rating agencies to make profits by selling valuable ratings to unscrupulous issuers.⁴²⁸ This problem could be in evidence in the structured finance sector where CRAs have an interest in maintaining their market share while companies have an interest in ensuring their access to capital. In particular, ratings of structured products involve ancillary services such as joint assessment of the composition of financial instruments and close collaboration with CRAs' staff in the risk analysis. However, as Frost has observed, it is very difficult to prove inappropriate behaviour between credit

⁴²⁷ Stephen Harper (note 422) 1971. The author argues that 'this tier-based system with liability caps should be adopted because it offers an appropriate model for deterring CRA misconduct without bankrupting CRAs'.

⁴²⁸ The concept of 'free-riding' was elaborated within the theory of public goods and it is defined as a situation in which an individual may be able to obtain the benefits of a good without contributing to the cost. See the classical work of James M. Buchanan, *The Demand and Supply of Public Goods* (Chicago: Rand-McNally, 1968). See also E.C. Pasour Jr., 'The Free Rider as a Basis for Government Intervention' (1981) 5 *The Journal of Libertarian Studies* 4, 453.

agencies and issuers on the account of discretionary rating methodologies used by CRAs.⁴²⁹

Although the practice of offering ancillary services raises many concerns, the real problem is the quality of the ratings process and the ongoing review of outcomes.⁴³⁰ This aspect is relevant because the perception of market participants that ratings are used to generate lucrative business could represent a wrong incentive for the CRA industry. The interference as between CRAs and issuers underlines the lack of independency of agencies in the formulation of ratings and casts doubt on the accuracy of rating models.⁴³¹

Reliance on CRAs' evaluations is determined by two main factors: (1) the limited competition in the ratings market, and (2) the absence of reputational deterrence. These factors constitute negative incentives for credit rating agencies in so far as they are not under any pressure to devote more effort (i.e. care) to their activities.

It should be noted that investors place great reliance on credit ratings not only because they trust leading CRAs but also because they lack the competence to understand the quality of ratings.⁴³² Of course, investors find it difficult to monitor the ratings methodologies—or the criteria used by CRAs—and they also find it difficult to constrain the agencies to update their models.

The subprime mortgage crisis revealed that CRAs were reluctant to incorporate new information (e.g. changes in the track records) in their quantitative models, while they followed the market by assessing outdated historical data.⁴³³

⁴²⁹ Carol Ann Frost, 'Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies' (2007) 22 *Journal of Accounting, Auditing & Finance* 3, 480.

⁴³⁰ Kee H. Chung, Carol Ann Frost and Myungsun Kim, 'Characteristics and Information Value of Credit Watches' (2012) 41 *Financial Management* 1, 120-121.

⁴³¹ John Flood, 'Rating, Dating, and the Informal Regulation and the Formal Ordering of Financial Transactions: Securitisations and Credit Rating Agencies' in Michael B. Likosky (ed.), *Privatising Development* (Leiden: Martinus Nijhoff Publishers 2005) 161.

⁴³² Angus Duff and Sandra Einig, 'Understanding credit ratings quality: Evidence from UK debt market participants' (2009) 41 *The British Accounting Review* 2, 110. The authors argue that 'ratings quality could be similarly described as reliant on two matters: the competence of the CRA (i.e., their ability to accurately assess the probability of default on a security); and second their independence (i.e., willingness to downgrade an issuer's security, or issue a lower rating than the issuer anticipated)'.⁴³³

⁴³³ Gerard Caprio Jr., Aslı Demirgüç-Kunt and Edward J. Kane, 'The 2007 Meltdown in Structured Securitization: Searching for Lessons, not Scapegoats' (2010) 25 *The World Bank Research Observer* 1, 134-135.

Paradoxically, the market relied on rating models for structured finance valuation mainly because of the complexity of financial instruments and on account of the high profits that well-rated products may secure for issuers.⁴³⁴ By contrast, CRAs are aware that market participants are not able to assess for themselves the value of the debt securities and use ratings as a universally accepted benchmark. For this reason, the CRAs tend to ignore the risks of financial losses of third counterparties.⁴³⁵

Whilst, on the one hand firms have strong incentives to maintain or improve their ratings, on the other hand, CRAs have strong incentives to adjust for bond issuers' opportunistic behaviours owing to their reputation concerns.⁴³⁶ As a result, the insufficient loan-level disclosure by originators and information asymmetries caused the over-reliance on CRAs that played a crucial role in the 2007-2009 financial crisis.⁴³⁷

At this point, it is possible to draw a first conclusion: misalignment of interests between investors and issuers, insufficient disclosure of rating agencies and insufficient attention to the quality of ratings have created the ideal ground for spreading blind reliance on CRAs.

It can be observed that market discipline—with its weak constraints favours the conditions for the increasing role of rating agencies. Further, regulatory over-reliance leads CRAs to give incorrect and biased credit ratings in the debt securities segment. However, the main problem stems from the wrong incentives provided by regulators and market participants that follow passively the practices of credit rating agencies.⁴³⁸

Having provided an analysis of market incentives in the CRA industry and the opportunistic behaviours of rating agencies, the next section deals with the

⁴³⁴ Michael J. Brennan, Julia Hein and Ser-Huang Poon, 'Tranching and Rating' (2009) 15 *European Financial Management* 5, 892.

⁴³⁵ Gary Gorton, 'The subprime panic' (2009) 15 *European Financial Management* 1, 38.

⁴³⁶ Boochun Jung, Naomi Soderstrom and Yanhua Sunny Yang, 'Earnings Smoothing Activities of Firms to Manage Credit Ratings' (2013) 30 *Contemporary Accounting Research* 2, 649. In particular, the authors observe that 'because credit ratings have significant cost implications for companies, including the cost of future borrowing and stock and bond valuations, managers have incentives to improve or maintain their credit ratings'.

⁴³⁷ Hans von Reden, 'Regulation of securitised products post the financial crisis' (2013) 2 *UCL Journal of Law and Jurisprudence* 1,116.

⁴³⁸ Vasiliki Skreta and Laura Veldkamp, 'Ratings shopping and asset complexity: A theory of ratings inflation' (2009) 56 *Journal of Monetary Economics* 5, 691. The authors argue that 'not only does the nature of the good being sold affect the information available about it, but also that the nature of the evaluated products may change to game the ratings system, possibly to disastrous effect'.

question of free-market interference in terms of facilitating a systematic dependence in ratings and favouring the artificially high demand for highly rated financial instruments.

2.13 Considerations about the free-market interference on the part of credit ratings

Ratings are mainly considered value tools for their purpose of labelling the risk of financial products whether their use ensures high profits or gains the access to the capital. Otherwise they can be considered speculative or aggressive tools in case of the inefficient signalling of the risk of default of firms.⁴³⁹

It is curious that, on the one hand, financial markets blame the activities of CRAs for their recent failures and, on the other, encourage those actors to play the role of arbiters of debt securities by endorsing rating references in the regulations. A possible reason lies in the direct impact of ratings in the structure of the financial system and in the capacity of CRAs to control access to funding.

Ratings have direct implications for the level of risk of securities as well as a direct involvement ‘with the assessment of the capital charge imposed on financial institutions’.⁴⁴⁰ Another reason lies in the CRAs’ ability to exacerbate the sensitivity of market participants to changes in credit ratings. It seems contradictory to identify the credit rating agencies as one of the most significant contributors to the 2007-2009 financial crisis when market behaviour amplified their role by recognising them as one of the most important forecasters in the capital markets.⁴⁴¹ It can be argued that the CRAs’ shortcomings are determined by the need of market participants to certify the quality of their financial products.

It does not matter whether the raters—in conflicts of interests—assess the securities positively, upgrade the creditworthiness of sovereign debt or ensure high ratings for the assets of issuers. However, what are the effects if the raters in conflicts of interest react too slowly, neglect relevant information or provide negative assessments of the profitability of the financial assets, downgrade the soundness of government debt or exacerbate the risk of default of financial firms?

⁴³⁹ Horatio M. Morgan, ‘Credit rating agencies and regulatory reform: the case of Moody’s Investors Services’ (2011) 26 *Journal of International Banking Law and Regulation* 8, 389-390.

⁴⁴⁰ Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford: OUP 2014) 634.

⁴⁴¹ European Central Bank, ‘Credit Rating Agencies: Developments and Policy Issues’ (May 2009) *Monthly Bulletin*, 107.

In this case, market participants could raise concerns about the inaccuracy of the ratings process, the lack of timeliness in issuing ratings and the lax assessments of credit risk.⁴⁴² It can be claimed that the credit market crisis was not generated by independent ratings errors or by involuntary inflated ratings.⁴⁴³

The assumption behind the above considerations is as follows: the possibility of flawed ratings is more likely when CRAs are pressured by the market's need to have reliable information about the riskiness of investments.⁴⁴⁴ In addition, the possibility of distorted ratings is more likely when CRAs are pushed by the issuers' high fees. This means that CRAs cannot be depicted as 'angels' in the securities markets but also cannot be described as 'devils' among investors.⁴⁴⁵

The rating agency reforms, the Dodd-Frank Act and the EU Regulations, have attempted to solve these issues but fail to give a convincing answer to the following fundamental question: to what extent does market behaviour contribute to CRAs' reliability and is it the real shortcoming in the ratings industry?

The important point is that market discipline has proved unable to reduce over-reliance on ratings activities.⁴⁴⁶ In particular, market forces alone have failed to reduce the regulatory use of credit ratings and this has contributed to investors' undue reliance on ratings and favoured artificially high demand for highly rated financial instruments.⁴⁴⁷ Market incentives alone seem to be inadequate to foster the accuracy of ratings and to keep the effectiveness of CRAs' action aligned with investor protection.

The crux of matter is that CRAs activities could face potential systemic risk because of the scant incentive to perform their screening accurately and because of the equally scant incentive for policymakers, institutional investors and global

⁴⁴² Paula Hill and Robert Faff, 'The Market Impact of Relative Agency Activity in the Sovereign Ratings Market' (2010) 37 *Journal of Business Finance & Accounting* 9-10, 1310.

⁴⁴³ Emily Lee, 'Basel III: post-financial crisis international financial regulatory reform' (2013) 28 *Journal of International Banking Law and Regulation* 11, 441.

⁴⁴⁴ Glen Biglaiser, Karl De Rouen Jr. and Candace C. Archer, 'Politics, Early Warning Systems, and Credit Rating Agencies' (2011) 7 *Foreign Policy Analysis* 1, 72. The authors observe that 'from a government's point of view, obtaining a rating is a way to assure international investors about the safety of their investments'.

⁴⁴⁵ Carlo R. W. de Meijer and Michelle H. W. Saaf, 'The credit crunch and credit rating agencies: Are they really striving towards more transparency?' (2008) 1 *Journal of Securities Law, Regulation & Compliance* 4, 332. The authors pointed out that 'while credit ratings can be good indicators as to the performance, risk and relative safety of products over a period of time, they must not be considered to be the sole guide for selecting one's investments'.

⁴⁴⁶ FSB, 'Thematic Review on FSB Principles for Reducing Reliance on Credit Rating Agency Ratings. Interim Report', 29 August 2013. 6.

⁴⁴⁷ Mark Zelmer, 'Reforming the Credit-Rating Process' (2007) *Financial System Review* 2, 56.

regulators to address the threats stemming from credit rating agencies.⁴⁴⁸ However, there is no consensus that CRAs have gained a ‘special position’ in the financial markets because of wrong incentives owing to free-market interference.⁴⁴⁹

CRAs have the power to influence a product’s value and pressure the expectations of market participants, but this power finds fertile ground in the over-reliance, i.e. overdependence, of investors. As Manns observed, ‘the ongoing influence of the leading rating agencies underscores the fact that markets continue to value their opinions’.⁴⁵⁰ This scenario leads to the following conclusion: in order to avoid failures on the part of CRAs, it is necessary that these agencies should resume their role of promoting financial awareness, but this can become a difficult task if market participants do not stop to rely to ratings.⁴⁵¹ In this way, credit rating agencies will continue to be criticized for their actions that are fundamentally convenient for issuers and investors.

After providing an analysis of the governance of the ratings industry by examining the problems of conflicts of interest, the disclosure regime and the limited competition of CRAs, and discussing the role of market discipline for reducing the systemic role of CRAs by considering its potential threat for the stability of securities markets, the next chapter examines the regulatory framework of CRAs.

⁴⁴⁸ Steven Dreibelbis and Jonathan Breazeale, ‘Rating the analysis in the current recession: a review of Moody’s and Standard and Poor’s’ (2012) 11 *Academy of Banking Studies Journal* 1, 67 where it is noted that the US government protects the main CRAs by reducing the regulation even though CRAs were accused of issuing faulty ratings.

⁴⁴⁹ Amy K. Rodhes, ‘The role of the SEC in the regulation of the rating agencies: well-placed reliance or free-market interference?’ (1996) 20 *Seton Hall Legislative Journal* 2, 295-296. The author argues that ‘...in facing competition from other rating agencies and security analysts, a rating agency has strong market incentives to assign credible ratings in order to maintain its reputation’ (at 296).

⁴⁵⁰ Jeffrey Manns, ‘Downgrading Rating Agency Reform’ (2013) 81 *George Washington Law Review* 3, 756.

⁴⁵¹ Tracy Alloway and Anjali Raval, ‘Blackstone rental bond gets triple A rating’ *Financial Times* (London, 23 October 2013), where an unexpected triple A credit rating was reported for a new bond deal and it was stated that ‘rating agencies had been slow to back the new rental bonds given there is little data to demonstrate historical cash flows and costs’.

Chapter Three

The Regulatory Framework of Credit Rating Agencies

3.1 *The International approach*

This chapter examines the legal framework of CRAs, in particular the intervention of global regulators and the legislative reforms adopted in the US, the UK and the EU in the aftermath of the sub-prime mortgage crisis and the subsequent credit crunch. It also considers the major weaknesses of these reforms and suggests proposals aimed at enhancing the current regulatory system.

The focus on rating agencies reflects long-standing difficulties in controlling conflicts-of-interest risk in the financial markets, and particularly in ‘gatekeeping’ sectors. Over the past decades, CRAs were criticized for their failure to foresee the difficulties of the Asian debt crisis in 1997 and to anticipate the collapses of big companies such as Enron, WorldCom and Parmalat at the beginning of the 2000s. These corporate scandals put the rating agencies and other ‘gatekeepers’ notably, auditors, in the spotlight of international debate and raised serious concerns about their performance in the financial markets.

Several initiatives have been undertaken as a result of the global consensus about the need to establish an adequate normative framework for CRAs.⁴⁵² The shortcomings of CRAs raised questions as to whether their lack of accountability could lead to persistent gaps in capital markets.⁴⁵³ During the 2007-2009 financial crisis and sovereign debt crisis (in particular the 2011-2012 Greek crisis) CRAs failed to provide adequate disclosure and transparency of their ratings methodologies. This led to the perception of CRAs as being virtually immune from responsibility to market participants.

⁴⁵² European Securities Markets Expert Group, ‘Role of Credit Rating Agencies’, ESME’s Report to the European Commission, June 2008. See also Bank for International Settlements, Committee on the Global Financial System, ‘The role of ratings in structured finance: issues and implications’, January 2005.

⁴⁵³ It should be noted that ‘accountability can be defined as an obligation owed by one person (the accountable) to another (the accountee) according to which the former must give account of, explain and justify his actions or decisions against criteria of some kind, and take responsibility for any fault or damage’. See Rosa M. Lastra and Heba Shams, ‘Public Accountability in the Financial Sector’, in Eilis Ferran and Charles Goodhart (eds), *Regulating Financial Services and Markets in the Twenty First Century* (Oxford: Oxford Hart Publishing 2001) 165-188.

The regulatory response to these failures was to consider the rating agencies as influential players in the financial sectors. Initial steps towards global attention on CRAs were taken in the direction of heightening the importance of CRAs as reputational gatekeepers and sources of quality control. As a result, CRAs were incorporated into the regulatory agenda of governments and legislators.⁴⁵⁴

In this respect, among the G-20 leaders there was a strong consensus that ‘all CRAs whose ratings are used for regulatory purposes should be subject to a regulatory monitoring regime’.⁴⁵⁵ However, the international approach at that time was characterized by soft regulatory measures, such as guidelines and recommendations, and by ‘pass the parcel’ policies.⁴⁵⁶ For instance, IOSCO initiated its regulatory efforts by assessing the quality and integrity of the rating process and by developing a set of principles that helped regulators to improve CRAs’ activity.

Rating agencies have come under close scrutiny owing to concern about their failure to convey risks in structured finance products, and related concerns as to the competence and conflict-of-interest risks to which rating agencies are exposed.⁴⁵⁷ In this context, ‘the regulatory and oversight programmes that have emerged worldwide as a result of the financial crisis have a degree of convergence that is unique in financial regulation’.⁴⁵⁸ The attention that regulators have dedicated to the ratings’ market was stepped up in the aftermath of the 2007-2009 financial crisis.

⁴⁵⁴ Group of Twenty (G-20), ‘Communiqué Meeting of Ministers and Governors’, São Paulo, Brazil, 8-9 November 2008, 2. It was stated that the credit rating agencies should be recognized as systemically important institutions and should be covered by proper oversight. This statement was reinforced in the 2008 Washington Summit, where G-20 leaders stressed the importance of taking action with respect to the governance of CRAs and in order to ensure that they meet the highest standards of the international organization of securities regulators. At the 2010 Toronto Summit, G-20 leaders underlined the need to work on reducing the reliance on external ratings, while at the Seoul Summit held in November 2010 the leaders firmly recommitted to work in an internationally consistent and non-discriminatory manner to strengthen the regulation and supervision of CRAs.

⁴⁵⁵ See the G-20 Declaration on Strengthening the Financial System, London Summit, 2 April 2009, 6. The leaders declared that they had ‘agreed on more effective oversight of the activities of Credit Rating Agencies, as they are essential market participants’.

⁴⁵⁶ Julia Black, ‘Gatekeepers’, Lecture presented at the London School of Economics and Political Science during the LL.M. course in Regulation of Financial Markets, 27 February 2009.

⁴⁵⁷ Niamh Moloney, ‘Reform or revolution? The financial crisis, EU financial markets law, and the European Securities and Markets Authority’ (2011) 60 *International and Comparative Law Quarterly* 2, 525.

⁴⁵⁸ Raquel García Alcubilla and Javier Ruiz del Pozo, *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (Oxford: OUP 2012) 259.

A relevant regulatory initiative taken at a global level was the publication in 2008 of a report prepared by the former Financial Stability Forum (today known as the Financial Stability Board)⁴⁵⁹ in which a set of measures for assessing the role and uses of credit ratings was proposed.⁴⁶⁰ In particular, the report contained a set of recommendations designed to increase the quality of the rating process and manage conflicts of interest related to the ‘issuer-pays’ model. The report focused on the deficiencies of CRAs in the area of structured finance products. The weaknesses of the business model of rating agencies were implicated on the back of the poor performance showed by them during the subprime mortgage bubble.⁴⁶¹

Following this report, the FSF issued follow-up documents reviewing progress in the implementation of the recommendations and the ongoing efforts carried out by national authorities and international bodies in order to enhance the supervision of CRAs.⁴⁶²

In 2010, the FSB published an important paper that fixed high-level principles for reducing reliance on CRAs ratings in standards, laws and regulations.⁴⁶³ This paper followed the report to G20 Finance Ministers and Governors issued to reinforce the need to work on reducing the reliance on external ratings.⁴⁶⁴

The principles contained in the 2010 Report aim to: (1) work as a catalyst towards effecting a significant change in existing rating practices; (2) tend mechanistic reliance by market participants; and (3) establish stronger internal credit risk assessment practices instead. However, the principles set out broad objectives to be implemented by regulators through incisive and specific actions.

⁴⁵⁹ The FSB has been established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory financial policies.

⁴⁶⁰ Financial Stability Forum, ‘Report on Enhancing Market and Institutional Resilience’, 7 April 2008.

⁴⁶¹ *ibid* 4. The Report underlines the importance of supervision and oversight of CRAs’ activity and advises agencies to: (1) implement the revised IOSCO Code of Conduct Fundamentals for Credit Rating Agencies to manage conflicts of interest in rating structured products and improve the quality of the rating process; and (2) differentiate ratings on structured credit products from those on bonds and expand the information they provide.

⁴⁶² FSF, ‘Report of the Financial Stability Forum on Enhancing market and Institutional Resilience. Follow-up on Implementation’, 10 October 2008; ‘Report of the Financial Stability Forum on Enhancing market and Institutional Resilience. Update on Implementation’, 2 April 2009.

⁴⁶³ FSB, ‘Principles for Reducing Reliance on CRA Ratings’, 27 October 2010.

⁴⁶⁴ FSB, ‘Reducing Reliance on CRA Ratings. Report to G20 Finance Ministers and Governors’, 14 October 2010.

The principles were endorsed by the G-20 leaders in November 2010 and represent a significant step towards reducing over-reliance on CRAs' ratings.⁴⁶⁵

The 2010-2012 sovereign debt crisis has raised questions as to the role of credit rating agencies in the financial markets. As a result, the accuracy of credit outlook and sovereign ratings behaviour came under the microscope.⁴⁶⁶

In 2012, the FSB published a far reaching document that contains proposals that are designed to: (1) reduce mechanistic reliance on CRA ratings through standards, laws and regulations; and (2) promote and, where needed, require that financial institutions strengthen and disclose information on their own credit risk assessment approaches as a replacement for mechanistic reliance on CRA ratings.⁴⁶⁷ At the same time, IOSCO issued two documents that focus on: (1) internal controls and safeguards against conflicts of interest⁴⁶⁸; and (2) establishing and operating supervisory colleges for rating agencies.⁴⁶⁹ The documents were published to address the existing risks that CRAs faced in terms of business operation and internal governance.

The 'soft law' approach adopted for CRAs proved to be incapable of addressing the major problems of rating agencies.⁴⁷⁰ This means that the global actions undertaken by international regulators did not have the desired effects of ensuring the reliability and integrity of the rating business.

It is paradoxical that 'neither IOSCO nor any other international body is currently in a position to determine whether or not a given CRA does, in fact, comply with its own code of conduct in the manner in which its public statements indicate'.⁴⁷¹

⁴⁶⁵ FSB, 'Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability. Report of the Financial Stability Board to G20 Leaders', 4 November 2011, 27.

⁴⁶⁶ John Kiff, Sylwia Nowak, and Liliana Schumacher, 'Are Rating Agencies Powerful? An Investigation into the Impact and Accuracy of Sovereign Ratings', IMF Working Paper No 23, January 2012, 25-26.

⁴⁶⁷ FSB, 'Roadmap and workshop for reducing reliance on CRA ratings. FSB report to G20 Finance Ministers and Central Bank Governors', 5 November 2012.

⁴⁶⁸ IOSCO, 'Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of the Credit Rating Process and Procedures to Manage Conflicts of Interest. Final Report', December 2012.

⁴⁶⁹ IOSCO, 'Supervisory Colleges for Credit Rating Agencies. Consultation Report', December 2012.

⁴⁷⁰ David Rouch, 'Self-regulation is dead: long live self-regulation' (2010) 4 *Law and Financial Markets Review* 2, 103. The author argues that 'the soft law/hard law interface has always been of crucial importance in the financial markets, reflecting the interdependence of public and private sectors in creating rules that work properly in practice'.

⁴⁷¹ IOSCO, 'International cooperation in oversight of credit rating agencies', March 2009, 3. The

The system of best practices in the ratings market cannot be considered a valid option for regulating and supervising CRAs. Self-regulation and market discipline have not worked because they have proved to be unsatisfactory both prior and during the financial crisis.⁴⁷² In this respect, it is easy to evoke Greenspan's famous lament '[t]hose of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief'.⁴⁷³

If CRAs' activities are global in nature, a comprehensive global rulebook and supervisory cooperation would, therefore, lead to more effective regulation with less risk of inaccurate ratings. It has been argued that 'a global principles-based rulebook (preferably based on the IOSCO Code) would effectively address the issue of conflicts of interest in the rating of structured finance products'.⁴⁷⁴

The adoption of a single set of rules for CRAs and common supervisory standards should help regulators to implement effective oversight and enforcement mechanisms.⁴⁷⁵ Although the task force launched by the global regulators produced significant results, the 2007-2009 global financial crisis has demonstrated that a more explicit reference to a hard law regime and legally binding measures would have been desirable. Hard law is binding in its coercive action and enforcement is the key element in distinguishing between hard and soft law. In order to promote accountability for CRAs, a robust legal and institutional framework, as well as a comprehensive and consistent approach, is needed. However, the powerful role of these market participants poses new challenges for regulators and supervisory authorities alike.

After providing a brief analysis of the recent international regulatory approach towards CRAs, the next section illustrates the early initiatives adopted by IOSCO to enhance the regulation of ratings.

document affirms that 'because the IOSCO CRA Code is viewed as the international consensus regarding the regulatory issues stemming from the activities of CRAs and the processes by which CRAs develop credit ratings, the IOSCO CRA Code can serve (and is serving) as a template for regulation of CRAs'.

⁴⁷² Piero Cinquegrana, 'The Reform of the Credit Rating Agencies: A Comparative Perspective', European Capital Markets Institute Policy Brief No 12, February 2009, 6.

⁴⁷³ Alan Greenspan, Testimony delivered at the House Committee on Oversight and Government Reform, Washington, 23 October 2008.

⁴⁷⁴ Tobias Johansson, 'Regulating credit rating agencies: The issue of conflicts of interest in the rating of structured finance products' (2010) 12 *Journal of Banking Regulation* 1, 13.

⁴⁷⁵ SIFMA, 'Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Task Force', July 2008, 11.

3.1.1 *The 2004 IOSCO Code: enforcement and ‘comply or explain’ model*

It is generally considered that IOSCO plays the role of both leader and follower with regard to the improved regulation of CRAs.⁴⁷⁶

In the aftermath of the corporate governance scandals such as Enron and WorldCom, the IOSCO Technical Committee formed a Task Force to examine certain issues regarding the role CRAs play in securities markets.⁴⁷⁷ The working group evaluated the disclosure system of rating agencies taking into account the questions of conflicts of interests and limited competition.

The outcomes of this activity were endorsed in the 2003 IOSCO Report. This contains a set of principles for securities regulators, rating agencies and others wishing to articulate the terms and conditions under which CRAs operate.⁴⁷⁸ The document focuses on the: (1) quality and integrity of the rating process; (2) independence and conflicts of interest; (3) transparency and timeliness of ratings disclosure; and (4) confidential information.

This report is accompanied by a “Statement of Principles Regarding the Activities of Credit Rating Agencies” (‘Principles’), which sets out recommendations for CRAs with the purpose of fostering investor protection and market transparency.⁴⁷⁹ The Statement stresses that the Principles do not set forth a ‘one-size-fits-all’ approach, but state high-level objectives which ratings agencies, regulators, issuers and other market participants should strive to achieve in order to improve the fairness, efficiency and transparency of the securities markets.⁴⁸⁰

In 2004, IOSCO issued a consultation draft of the Code Fundamentals⁴⁸¹, a first step towards the publication of more prescriptive final “Code of Conduct Fundamentals for Credit Rating Agencies” (‘2004 Code of Conduct’).⁴⁸² This 2004 Code of Conduct was conceived to provide a set of practical measures to be

⁴⁷⁶ Roberta S. Karmel, ‘IOSCO’s Response to the Financial Crisis’ (2012) 37 *The Journal of Corporation Law* 4, 874. The author observes that ‘when national interests are at stake, securities regulators follow those interests rather than IOSCO directives’.

⁴⁷⁷ The Task Force drafted a questionnaire and circulated it among its members in order to obtain a better understanding of how CRAs operate in different IOSCO jurisdictions.

⁴⁷⁸ IOSCO, ‘Report on the Activities of Credit Rating Agencies’, September 2003.

⁴⁷⁹ IOSCO, ‘Statement of Principles Regarding the Activities of Credit Rating Agencies’, 25 September 2003.

⁴⁸⁰ *ibid* 1.

⁴⁸¹ IOSCO, ‘Code of Conduct Fundamentals for Credit Rating Agencies. A Consultation Report of the Chairmen’s Task Force of the Technical Committee’, October 2004.

⁴⁸² IOSCO, ‘Code of Conduct Fundamentals for Credit Rating Agencies’, December 2004, 2.

used as a guide to implementing the objectives underlying the Principles. The 2004 Code of Conduct addresses the following areas: (1) the quality and integrity of rating process; (2) the independence of CRAs and avoidance of conflicts of interest; and (3) the responsibilities to the investing public and issuers.⁴⁸³ It includes rules of both a prohibiting and preventative nature as well as general requirements specifically intended to ensure either company or employee independence.

In this respect, the 2004 Code of Conduct's attractiveness has been said to lie in the fact that it is flexible and lends itself to adoption by CRAs varying in size, rating methodologies, and business models, and provides for moderate regulatory oversight without the employment of costly and burdensome formal regulatory oversight.⁴⁸⁴

Despite the fact that the main objective of the 2004 Code of Conduct was to promote investor protection by safeguarding the integrity of the rating process, the rules were not designed to be rigid or formulaic.⁴⁸⁵ They were instead designed to offer CRAs a degree of flexibility as to how these measures are incorporated into the individual codes of conduct of the CRAs themselves.

IOSCO allowed each jurisdiction to decide autonomously the means of giving effect to the Principles, without aiming to impose or endorse any particular regulatory requirements regarding CRAs.⁴⁸⁶

The Principles and the 2004 Code of Conduct do not constitute legally binding obligations and are mainly based on soft law mechanisms and voluntary compliance. Nonetheless, one observer finds that 'the Code is an exercise in prescriptive regulation that takes direct aim at CRAs and seeks to inform both its internal governance and measures to maintain objectivity of ratings'.⁴⁸⁷

IOSCO requires CRAs to publish how each provision of the 2004 Code of Conduct has been implemented by the respective CRA, and disclose the reasons

⁴⁸³ The measure 2.5 of the IOSCO Code of Conduct advises that 'the CRA should separate, operationally and legally, its credit-rating business and analysts from any other business of the CRA, including consulting businesses that may present a conflict of interest'.

⁴⁸⁴ Peter Yeoh, 'Self-Regulation, Regulation, Co-Regulation: The Credit Rating Industry Case' (2013) *Journal of Business Law* 2, 192.

⁴⁸⁵ IOSCO (note 482) 3.

⁴⁸⁶ Ryan Voorhees, 'Rating the Raters: Restoring Confidence and Accountability in Credit Rating Agencies' (2012) 44 *Case Western Reserve Journal of International Law* 3, 884.

⁴⁸⁷ Chris Brummer and Rachel Loko, 'The New Politics of Transatlantic Credit Rating Agency Regulation' in Tony Porter (ed.), *Transnational Financial Regulation After the Crisis* (London and New York: Routledge 2014) 12.

for non-publication if this is not forthcoming. The 2004 Code of Conduct adopts the ‘comply or explain’ model in the sense that compliance is not mandatory and any deviations are not presumed to constitute non-implementation of the 2004 Code of Conduct’s mandates.⁴⁸⁸ It has been noted that ‘the essence of comply or explain principle is that compliance with the codes is not mandatory, but that disclosure relating to compliance is’.⁴⁸⁹

One can argue that this approach leaves market participants completely self-regulated through principles and right behaviours. While the 2004 Code of Conduct can be considered to be an initial experiment with enforcement, the workability of its provisions depends on CRAs themselves implementing effective enforcement mechanisms. There is, of course, no guarantee that this will happen given the absence of a monitoring agent.

It has been observed that ‘the effectiveness of soft laws, like the 2004 Code of Conduct, can be effectively enhanced when market users with good reasons to enforce deviations exert appropriate pressures by withdrawing business or support from those CRAs with serious ratings reputation problems’.⁴⁹⁰

The failure of CRAs to prevent and effectively handle the 2007 subprime mortgage crisis, the collapse of Lehman Brothers in 2008, as well as the rapid spread of structured finance ratings (mortgage-backed securities and collateralised debt obligations) determined a radical change in the self-regulatory regime introduced by the 2004 Code of Conduct.⁴⁹¹

These factors raised many concerns about the conduct and efficacy of rating agencies but most importantly revealed the high reliance on the judgement of CRAs even when they were manifestly inaccurate and exhibited poor diligence.

⁴⁸⁸ Section 4.1 of the 2004 IOSCO Code of Conduct.

⁴⁸⁹ Iain MacNeil and Xiao Li, ‘“Comply or Explain”: market discipline and non-compliance with the Combined Code’ (2006) 1 *Corporate Governance* 5, 486. The authors underline the disclosure obligation contained in the “comply or explain” approach to corporate governance codes in the United Kingdom. See also Sridhar Arcot, Valentina Bruno and Antoine Faure-Grimaud, ‘Corporate governance in the UK: Is the comply or explain approach working?’ (2010) 30 *International Review of Law and Economics* 2, 198; Andrew Keay, ‘Comply or explain in corporate governance codes: in need of greater regulatory oversight?’ (2014) 34 *Legal Studies* 2, 279.

⁴⁹⁰ Peter Yeoh, ‘External Credit Assessment Institutions: Clash of Expectations and Accountability Issues’ (2012) 12 *Journal of Corporate Law Studies* 2, 427.

⁴⁹¹ David J. Matthews, ‘Ruined in a Conventional Way: Responses to Credit Ratings’ Role in Credit Crises’ (2009) 29 *Northwestern Journal of International Law & Business* 1, 248-250.

For this reason, IOSCO published in 2008 a revised version of the 2004 Code of Conduct ('2008 Code of Conduct').⁴⁹² This revised version was published to fill the gaps of the 2004 Code of Conduct, particularly with respect to structured finance ratings. The major amendments introduced in the 2008 Code of Conduct are: (1) a prohibition of 'opinions and recommendations' concerning structured finance⁴⁹³; (2) the different labels for structured finance ratings⁴⁹⁴; (3) advice to assist investors in understanding limitations of ratings⁴⁹⁵; (4) advice for CRAs to define ancillary business⁴⁹⁶; and (5) advice to assess the rating methodologies.⁴⁹⁷

In substance, CRAs are advised to discourage 'ratings shopping' and to disclose in their rating announcements all relevant information concerning the product being rated. To mitigate the practice of giving financial firms the most favourable evaluations, CRAs should reduce their efforts to gain more business with issuers and, instead, improve the disclosure of ratings methodologies. As discussed in Chapter three, the close relationship between CRAs and issuers may determine a selection bias that results in an acceleration in loosening underwriting standards and a deterioration in the quality of the loans that underpin the bonds.⁴⁹⁸

The 2008 Code of Conduct addresses two main questions namely an 'overwhelming reliance' by investors on CRAs and the issue of limited investor monitoring in investment decisions. However, the 2008 Code of Conduct adopted a non-binding regulatory approach that did not reduce the reliance by market participants on the ratings of CRAs. In particular, the 2008 Code of Conduct underlined the difficulties for investors to understand the rating label (i.e. different labels for structured finance ratings) and the methodologies used by CRAs to assess financial products. These difficulties were exacerbated by a 'chronic lack of private sector discipline and competence...in the global financial regulatory framework' does not come to evaluating the ratings process.⁴⁹⁹

⁴⁹² IOSCO, 'Code of Conduct Fundamentals for Credit Rating Agencies. Revised', May 2008.

⁴⁹³ Measure 1.14-1 of the 2008 IOSCO Code of Conduct.

⁴⁹⁴ Measure 3.5(b) of the 2008 IOSCO Code of Conduct.

⁴⁹⁵ Measure 3.5(a)(c) of the 2008 IOSCO Code of Conduct.

⁴⁹⁶ Measure 2.5 of the 2008 IOSCO Code of Conduct.

⁴⁹⁷ Measure 1.7 of the 2008 IOSCO Code of Conduct.

⁴⁹⁸ Tracy Alloway, 'Ratings shopping' makes a comeback in the US' *Financial Times* (London, 15 September 2014).

⁴⁹⁹ Charlie McCreevy, 'Financial Turmoil: latest developments on policy response', ECON Committee, Brussels, 10 September 2008, 2.

In response to this, in 2009 IOSCO published the “Review of Implementation of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies”⁵⁰⁰ and launched a consultation report to address several regulatory initiatives that impacted CRAs in multiple jurisdictions.⁵⁰¹ Consequently, in February 2011 the IOSCO Technical Committee issued the final report “Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies”.⁵⁰² This document sets out the various ways in which CRAs regulatory programmes promote the objectives of the IOSCO CRAs principles.

The 2015 IOSCO Code of Conduct Fundamentals for Credit Rating Agencies provided a set of guidelines and practical measures for implementing the governance of ratings industry aiming at enhancing transparency of information.⁵⁰³ The IOSCO measures intend to address the following objectives: (1) quality and integrity of the credit rating process; (2) CRA independence and the avoidance of conflicts of interest; (3) CRA responsibilities to the investing public, rated entities, obligors, underwriters and arrangers; (4) risk management and employee training; and (5) disclosure and communication with market participants.

As mentioned, IOSCO Codes and Principles do not entail enforcement mechanisms, apart from peer pressure, and they do not oblige market participants to comply with them. This means that the implementation of the codes of conduct is to be enforced through market discipline. In this respect, the CRAs’ *modus operandi* is regulated by forms of ‘soft law’ i.e. rules that are not legally binding but which in practice are observed in a voluntary, self-imposed way.⁵⁰⁴ As a result, flexibility and informality are the main characteristics of the rules contained in the IOSCO Codes and Principles.

It is evident that IOSCO was drawn up with the expectation that market pressures would induce CRAs fully to comply with the Codes, as failure to do so would have an adverse impact on the reputation of the CRA in the financial market. Nonetheless, the 2007-2009 global financial turmoil as well as the 2010-

⁵⁰⁰ IOSCO, ‘A Review of Implementation of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies’, March 2009.

⁵⁰¹ IOSCO, ‘Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies. Consultation Report’, May 2010.

⁵⁰² IOSCO, ‘Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies. Final Report’, February 2011.

⁵⁰³ IOSCO, ‘Code of Conduct Fundamentals for Credit Rating Agencies’ (Revised March 2015) 3.

⁵⁰⁴ Roy Goode, *Commercial Law* (London: 2nd ed. Penguin Books 1995) 20-21.

2012 EU sovereign debt crisis has demonstrated the incapacity of the market to regulate the systemic role of rating agencies.

The Basel III Accord has confirmed that the 2008 Code of Conduct is the international benchmark for CRAs' rules of conduct. According to the Basel III rules, national supervisors should refer to the 2008 Code of Conduct when determining External Credit Assessment Institution (ECAI) eligibility.⁵⁰⁵ This confirms the importance of 2008 Code of Conduct in setting a common framework to monitor CRAs' activities in their own jurisdictions.

It can be claimed that although IOSCO is devoted to establishing harmonized international standards for the regulation of securities, its interventions tend to be at a level of generality that may be considered insufficient to reform the regulatory framework of CRAs.

After considering the role played by IOSCO on developing the regulatory tools for CRAs, the next section examines the function of ECAIs taking into account the debate about their accountability and integrity as financial gatekeepers.

3.1.2 The function of external credit assessment institutions under the Basel Capital Accords

The European Central Bank defined an external credit assessment institution (ECAI) as 'an institution whose credit assessments may be used by credit institutions for determining the risk weight of exposures according to the Capital Requirements Directive'.⁵⁰⁶

The term ECAI was first used in the Basel II framework, although the text did not provide a clear definition.⁵⁰⁷ The Basel Committee states that 'external ratings that can be used for the capital purposes, according to the Basel II framework, are limited to the ratings provided by recognized ECAIs'.⁵⁰⁸

ECAIs play an important function in the regulatory standards of capital requirements (especially in the so-called pillar I 'Minimum Capital Requirements')

⁵⁰⁵ Basel Committee on Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems', June 2011, 52.

⁵⁰⁶ ECB, 'The Implementation of Monetary Policy in the Euro Area', September 2006, 45.

⁵⁰⁷ Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards. A Revised Framework', June 2004, Sections B and C, paras 90-108.

⁵⁰⁸ Basel Committee on Banking Supervision, 'Stocktaking on the use of credit ratings', The Joint Forum, June 2009, 19.

of Basel II)⁵⁰⁹ and in setting capital models for credit risk.⁵¹⁰ The regulatory measures for ECAIs undertaken by Basel II can be considered as a typical example of *ad hoc* regulation; one in which CRAs are regulated by a system of principles and standards.⁵¹¹

The Basel Committee affirmed that rating systems are a cornerstone for the calculation of banks' regulatory capital charge. This is according to the 'internal ratings-based approach' of Basel II because they are the basis for the determination of a borrower's probability of default.⁵¹²

The regulation of ECAIs under the Basel II Capital Accord was incorporated into EU legislation through the former CRD (today CRD IV).⁵¹³ The CRD established for the first time a framework of recognition of CRAs as ECAIs by competent European authorities (a regime similar to the US NRSRO as explained in Chapter two).

According to the CRD, an eligible ECAI is an entity that issues external credit assessments to be used for the determination of risk weights.⁵¹⁴ The CRD set out the main criteria which CRAs must satisfy in order to be recognised as ECAIs and allows the use of credit ratings in the determination of capital requirements for banks and investment firms.⁵¹⁵

This recognition was granted only if the competent authorities were satisfied that the ECAI's assessment methodology complied with the requirements of

⁵⁰⁹ Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards', June 2006, 27-29.

⁵¹⁰ Under Basel II, banks used ratings assigned by recognized CRAs in determining credit risk weights for many of their institutional credit exposures. See Kern Alexander, 'Bank capital regulation and the role of external ratings: Unresolved issues' in Jan Kleineman, Lars Gorton and Aron Verstandig (eds.), *Perspectives on Credit Rating Agencies* (Stockholm: Författarna, Stockholm Centre for Commercial Law Jure Förlag AB 2013) 235-236.

⁵¹¹ Pavlos Maris, 'The regulation of credit rating agencies in the US and Europe: historical analysis and thoughts on the road ahead' (2009) <<http://ssrn.com/abstract=1434504>> accessed 27 March 2013, 6.

⁵¹² Basel Committee on Banking Supervision, 'Studies on the Validation of Internal Rating Systems', Working Paper No 14, May 2005, 7.

⁵¹³ Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (OJ 2006 L 177, p. 1). The Directive has been replaced by Directive 2013/36/EU on access to the activity and the prudential supervision of credit institutions and investment firms—Capital Requirements Directive IV (OJ 2013 L 176, p. 338). Recital 73 in the preamble to the Capital Requirements Directive IV provides that 'the recognition of a credit rating agency as an external credit assessment institution (ECAI) should not increase the foreclosure of a market already dominated by three undertakings. EBA, the Member States' central banks and the ECB, without making the process easier or less demanding, should provide for the recognition of more credit rating agencies as ECAIs in order to open the market to other undertakings'.

⁵¹⁴ Annex VI, Part 3, para 1 to Directive 2006/48/EC.

⁵¹⁵ Article 81(1) of Directive 2006/48/EC.

objectivity, independence, ongoing review and transparency, and that the resulting credit assessments met the requirements of credibility and transparency.⁵¹⁶

A set of guidelines for the recognition of eligible ECAIs was developed by the Committee of European Banking Supervisors (today referred to as the European Banking Authority).⁵¹⁷ The guidelines were revised in response to the amendments to Articles 81(2) and 97(2) of the CRD.⁵¹⁸ The amendments ensured that where an ECAI is registered as a CRA at EU level, there is no duplication of work required by the recognition processes of the CRD and the EU Regulation on CRAs.

The CRD allowed institutions to use external credit assessments to determine the weight of risk of their exposures, provided that the ECAIs that produce those assessments have been recognised as eligible for that purpose by the competent supervisory authorities (the ‘mapping process’).⁵¹⁹

Where an ECAI was registered as a CRA in accordance with EU Regulation No 1060/2009, the competent authorities were to consider the requirements of

⁵¹⁶ Article 81(2) of Directive 2006/48/EC.

⁵¹⁷ Committee of European Banking Supervisors, ‘Guidelines on the recognition of External Credit Assessment Institutions’, 20 January 2006. The Committee of European Banking Supervisors (CEBS) was established by Commission decision in 2003 and focused on the huge project for the introduction of risk-based capital requirements in the EU banking sector through the implementation of Basel II. The CEBS under level three of the Lamfalussy structure played a huge role in ensuring banking supervisory convergence by laying down best practices, guidance, standards and non-legally binding principles.

The Lamfalussy structure was inserted into the EU Financial Services Action Plan (FSAP) adopted by European Commission in 1999. The Lamfalussy regulation was characterized by four level of rules: level one consisted of principle-based legislation, adopted as before under the co-decision procedure; level two consisted of detailed implementing measures, consisting either of Commission directives or regulations, made under powers conferred by the Level 1 directive, under a new streamlined accelerated legislative procedure, in which the Commission is assisted by the European Securities Committee and the Committee of European Securities Regulators (CESR); level three ensured cooperation between the members of CESR concerning proper implementation of level one and level two measures; level four concentrated on more effective enforcement of compliance with EU legislation. On 1 January 2011, the European Banking Authority (EBA), established after the implementation of the “de Larosière Report”, replaced the CEBS’ tasks and responsibilities. For an academic view of the Lamfalussy process see Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford: OUP 2014) 862-864; Niamh Moloney, ‘The Lamfalussy Legislative Model: A New Era for the EC Securities and Investment Services Regime’ (2003) 52 *International and Comparative Law Quarterly* 2, 512-513. See also Rosa M Lastra, ‘The governance structure for financial regulation and supervision in Europe’ (2003) 10 *Columbia Journal of European Law* 1, 62-63.

⁵¹⁸ Committee of European Banking Supervisors, ‘Revised Guidelines on the recognition of External Credit Assessment Institutions’, 30 November 2010. The CEBS reviewed the 2006 guidelines to ensure consistency between Regulation (EC) No 1060/2009 and the amendments to Directive 2006/48/EC.

⁵¹⁹ Basel Committee on Banking Supervision, ‘International Convergence of Capital Measurement and Capital Standards. A Revised Framework’, June 2006, 28.

objectivity, independence, ongoing review and transparency with respect to its assessment methodology.⁵²⁰

The CRD permitted Member States to recognize an ECAI as eligible in two ways: (1) direct recognition, in which the competent authority carries out its own assessment of the ECAI's compliance with the CRD's eligibility criteria; and (2) indirect recognition, in which the competent authority recognizes the ECAI without carrying out its own evaluation, relying instead on the recognition of the ECAI by the competent authority of another Member State.⁵²¹

The Basel II Accord made clear that ECAI recognition provides a basis for risk-weighted capital requirements calculations under the 'Standardized Approach'⁵²² and 'Securitisation Ratings Based Approaches'.⁵²³ Such approaches are designed to increase the risk sensitivity of capital requirements for banks. They also seek to ensure that institutions using these approaches have appropriate levels of regulatory capital to support their aggregate credit risk.⁵²⁴

Under the CRD IV and Capital Requirements Regulation (CRR)⁵²⁵, approval as an ECAI is no longer required since registration or certification is the only requirement under CRA Regulation for EU financial institutions to rely on ratings.⁵²⁶ This means that a CRA registered under the CRA Regulation is directly recognized as an ECAI. However, the CRD IV does not reduce the reliance on ECAs for financial institutions to use when lending in the loan markets.⁵²⁷

⁵²⁰ Committee of European Banking Supervisors (note 517) 1.

⁵²¹ Article 97 of Directive 2006/48/EC.

⁵²² Under the 'standardized approach', banks that engage in less complex forms of lending and credit underwriting and that have simpler control structures may use external measures of credit risk to assess the credit quality of their borrowers for regulatory capital purposes. See Kern Alexander, 'The Risk of Ratings in Bank Capital Regulation' (2014) 25 *European Business Law Review* 2, 302.

⁵²³ Under the 'Securitization Ratings Based Approaches', banks must apply the securitization framework for determining regulatory capital requirements on exposures arising from traditional and synthetic securitizations or similar structures that contain features common to both. See Kern Alexander, Rahul Dhumale and John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (Oxford: OUP 2006) 41.

⁵²⁴ Committee of European Banking Supervisors (note 517) 1.

⁵²⁵ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L176/1).

⁵²⁶ Article 4(1) of the Regulation (EU) No 575/2013 provides that 'external credit assessment institution or "ECAI" means a credit rating agency that is registered or certified in accordance with Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies or a central bank issuing credit ratings which are exempt from the application of Regulation (EC) No 1060/2009'.

⁵²⁷ Kern Alexander, 'Bank capital regulation and the role of external ratings: Unresolved issues' in Jan Kleineman, Lars Gorton and Aron Verstandig (eds.), *Perspectives on Credit Rating Agencies*

The ECAI recognition process aims to ensure that the ratings are appropriate for supervisory and capital purposes.⁵²⁸ An ECAI must demonstrate that its methodology incorporates factors known to be relevant in determining an entity's creditworthiness. For their part, competent authorities have to verify that the methodology for assigning credit assessments is rigorous, systematic, continuous, and subject to validation based on historical experience.⁵²⁹

The authorities assess the independence of the ECAI's methodology according to: (1) the ownership and organisation structure of the ECAI; (2) the financial resources of the ECAI; (3) the staffing and expertise of the ECAI; and (4) the corporate governance of the ECAI. The ECAI's methodology is evaluated for its capacity to ensure ongoing review responsibly and for its ability to maintain transparency and provide a disclosure of credit assessments.⁵³⁰

As reputational gatekeepers, the credibility and reliability of ECAIs is measured by the user's confidence in such credit assessments. The greater the market acceptance, the higher this level of confidence is likely to be. But an ECAI's credibility can be determined on the basis of its market share, revenues, and whether there is any pricing on the basis of the rating.⁵³¹

ECAI's activities raise the issue of 'how important it is for external rating agencies to retain credibility by posting ratings for bank loans that will prove to be ex post accurate'.⁵³² The ECAIs' performance has come under fire for its handling of the 2007-2009 financial crisis when it failed adequately to assess the risk associated with securitisation exposures. The crisis has demonstrated that external credit ratings did not adequately reflect the risk of certain structured finance asset

(Stockholm: Författarna, Stockholm Centre for Commercial Law Jure Förlag AB 2013) 247.

⁵²⁸ Basel Committee on Banking Supervision (note 508) 19.

⁵²⁹ Committee of European Banking Supervisors (note 517) 17. CEBS guidelines recommend that 'the integrity of the credit assessment process should be ensured by adequate written internal procedures, corporate governance rules, fee policies, and, where relevant, an internal code of conduct' (at 21).

⁵³⁰ However, the CRD did not specify the level of detail that is required or the manner in which the information should be disclosed. For ECAIs which were registered under the 2009 EU Regulation on CRAs, the fulfilment of the criterion on transparency and disclosure of individual credit assessments can be assumed by the competent authority.

⁵³¹ Kern Alexander, 'Bank Capital Management and Macro-Prudential Regulation' (2012) 24 *Journal of Banking Law and Banking*, 336-337.

⁵³² Patrick Honohan, 'Perverse Effects of a Ratings-Related Capital Adequacy System', World Bank, Policy Research Working Paper Series No 2364, 2000, 2.

classes such as mortgage backed securities and resecuritisation positions i.e. the pool contains at least one tranching exposure.⁵³³

The growing demand for rating services, which has been driven by the advent of new structured finance product, has also contributed to the ECAs being more in the spotlight. It has been noted that the banks, which were creating asset-backed securities and products based on them, paid ratings agencies to rate the securitized products in order to improve their marketability to investors.⁵³⁴ For this reason, at the regulatory level, there was a large consensus in favour of revising the normative regime of external ratings.⁵³⁵ The legal framework was reviewed and provided with new measures that aimed to make capital requirements more prudent and risk sensitive and mitigate mechanistic reliance on external credit assessment.

The inadequacy of Basel II provisions to prevent banks from reducing their capital charges by pooling loans in off-balance-sheet vehicles gave rise to significant changes through the new Basel III Accord.⁵³⁶ The latter modifies some rules concerning the activity of ECAs. Paragraph 121 of the Accord now states that ‘banks will not be allowed to ‘cherry-pick’ the assessments provided by different ECAs and arbitrarily change the use of ECAs’.⁵³⁷

These changes were introduced following the 2009 Basel Consultative Document.⁵³⁸ This paper underlines the need to: (1) reduce the excessive reliance by many market participants, including banks, on external ratings; and (2) enhance the necessary due diligence, in order more fully to understand the risks underlying the rated instrument.

⁵³³ Basel Committee on Banking Supervision, ‘The Proposed Revised Ratings-Based Approach’, Working Paper No 23, January 2013, 3.

⁵³⁴ Julia Black, ‘Forms and Paradoxes of Principles Based Regulation’ LSE Law, Society and Economy Working Papers 13/2008, 10.

⁵³⁵ Basel Committee on Banking Supervision, ‘Revisions to the Basel Securitisation Framework’, Consultative Document, December 2012, 4. The paper states that the emphasis placed on credit ratings within the Basel securitization framework resulted in rating agency errors flowing through to regulatory capital requirements.

⁵³⁶ Basel Committee on Banking Supervision, ‘Basel III: A global regulatory framework for more resilient banks and banking system’, December 2010 (rev June 2011) 52-53. For an academic view see Markus K. Brunnermeier, ‘Deciphering the Liquidity and Credit Crunch 2007-2008’ (2009) 23 *Journal of Economic Perspectives* 1, 81; Emily Lee, ‘The soft law nature of Basel III and international financial regulations’ (2014) 29 *Journal of International Banking Law and Regulation* 10, 605-606.

⁵³⁷ Basel Committee on Banking Supervision (note 505) 54.

⁵³⁸ Basel Committee on Banking Supervision, ‘Strengthening the resilience of the banking sector’, Consultative Document, December 2009, 55.

Although regulators and lawmakers have developed some improvements, the complexity and difficulty of the ECAIs' structure do not favour an effective implementation of new rules. Under the Basel II framework, banking regulators allowed banks to use credit ratings from approved ECAIs when setting their capital requirements.⁵³⁹ As has been argued, 'by giving banks the flexibility to adjust their regulatory capital according to a mix of rating agency ratings and the respective banks' internal models, Basel II outsources significant regulatory authority to the models of rating agencies and banks'.⁵⁴⁰

As long as banks are permitted to make extensive use of ratings for capital adequacy purposes, their internal rating scales will continue to be dependent on the ECAIs' ratings.⁵⁴¹ In this light, the introduction of alternative sources of credit quality information could lead to and stimulate ECAIs to be accurate and transparent.⁵⁴²

After providing an analysis of the regulatory framework of CRAs set out by national and global regulators, the following section provides an analysis of the US legal framework. In doing so it takes into account the authorization system for CRAs established by the NRSRO.

3.2 The US Nationally Recognized Statistical Rating Organization authorization system of granting licenses

In terms of US legislation, CRAs are currently subject to regulation by the SEC. This section analyses the US system of authorization and recognition of CRAs as a NRSRO.⁵⁴³ The importance of this discussion lies in the significant role authorized by the NRSRO in allowing the use of ratings within the regulatory

⁵³⁹ John Authers, 'Who will teach responsibility in a buck-passing world?' *Financial Times* (London, 22 June 2014), where it is pointed out that 'the "Basel II" bank regulations gave investors a big incentive to buy anything stamped triple A by agencies. Ratings were only ever advertised as opinions, based on publicly available information: the agencies fell short when investment banks started trying to persuade them that products based on subprime mortgages should be rated triple A'.

⁵⁴⁰ Erik F. Gerding, 'Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis' (2009) 84 *Washington Law Review* 2, 157.

⁵⁴¹ Angus Duff, 'The credit ratings agencies and stakeholder relations: issues for regulators' (2009) 24 *Journal of International Banking and Financial Law* 1, 11.

⁵⁴² Basel Committee on Banking Supervision, 'Credit ratings and complementary sources of credit quality information', Working Papers No 3, August 2000, 4.

⁵⁴³ Josh Wolfson and Corinne Crawford, 'Lessons From The Current Financial Crisis: Should Credit Rating Agencies Be Re-Structured?' (2010) 8 *Journal of Business & Economics Research* 7, 85-90.

framework. By conferring on ratings the power to determine the credit risk of assets, financial institutions incautiously placed much reliance on CRAs' activities. This section also considers the major issues that the system of an NRSRO highlighted within the ratings industry. Amongst these, are barriers to entry, poor competition and overreliance by regulators. It is argued that the creation and development of an NRSRO system has provided ratings with the status of special label for the quality of debt instruments.

As indicated in Chapter one, the SEC established the NRSRO, a designation body, to ensure that bank issuers would not simply be drawn towards credit rating agencies whose only purpose was to deliver high ratings on financial instruments.⁵⁴⁴

The NRSRO was empowered by Rule 15c3-1 (the 'Net Capital Rule')⁵⁴⁵—adopted by the SEC in 1973. This incorporated credit ratings but only those ratings promulgated by what it defined as an NRSRO.

The 'Net Capital Rule' was essentially designed to ensure 'that registered broker-dealers have adequate liquid assets to meet their obligations to their investors and creditors'.⁵⁴⁶ This rule encouraged securities regulators to increase their reliance on ratings. The regulatory dependence on ratings started in 1973 when the SEC proposed amending broker-dealer 'haircut' requirements. These stipulated the percentage of a financial asset's market value a broker-dealer was required to deduct for the purpose of calculating its net capital requirement.⁵⁴⁷

⁵⁴⁴ Emily McClintock Ekins and Mark A. Calabria, 'Regulation, Market Structure, and Role of the Credit Rating Agencies' (2012) Cato Institute, Policy Analysis No 704, 8.

⁵⁴⁵ In 1973, the SEC adopted Rule 15c3-1 (the 'net capital' rule) to incorporate credit ratings, but only those ratings promulgated by what it defined as 'Nationally Recognized Statistical Ratings Organizations'. Rule 15c3-1 was the first securities rule to recognize the validity of credit ratings. In fact, this rule required a different framework for securities based on credit ratings assigned by NRSROs. However, Rule 15c3-1 created heavy barriers to entry for new rating agencies in the US because it gave preferential treatment to bonds rated investment-grade by at least NRSROs. In substance, Rule 15c3-1 strongly encouraged broker-dealers to invest in rated bonds, increasing the ratings' market power. Rule 15c3-1(c)(2)(vi)(F) of the 1934 Securities Exchange Act permitted registered broker-dealers to use ratings to value bond assets for the purposes of determining net capital requirements.

⁵⁴⁶ Michael P. Jamroz, 'The Net Capital Rule' (1992) 47 *The Business Lawyer* 3, 863. The author underlines the purpose of the Rule in protecting the customers and creditors of registered broker-dealers from monetary losses and delays that can occur when a registered broker-dealer fails.

⁵⁴⁷ Rule 15c3-1(c)(2)(vi)(F) of the 1934 Securities Exchange Act permitted registered broker-dealers to use ratings to value bond assets for the purposes of determining net capital requirements. See Steven L. Molinari and Nelson S. Kibler, 'Broker-Dealers' Financial Responsibility Under the Uniform Net Capital Rule—a Case for Liquidity' (1983) 72 *Georgetown Law Journal* 1, 5-7.

At the same time, the SEC incorporated ‘rules that restricted the extent to which a firm could hold assets that fell below investment grade and provisions that linked capital requirements to the ratings on individual securities, with lower capital charges for high-rated securities’.⁵⁴⁸

In particular, regulations required that ratings be issued from an NRSRO designated by the SEC. As a result, the rating agencies that did not possess ‘NRSRO status’ were excluded from a significant portion of the market. A ‘Catch 22’ scenario characterized the acquiring of NRSRO status. In essence, to attain such a designation, a CRA must be nationally recognised, but a CRA cannot become nationally recognized without first having the designation.⁵⁴⁹ One can argue that regulations encouraged investors to purchase financial instruments with high NRSRO credit ratings, rather than credit ratings with high informational value.

Before the 1970s, credit ratings were regulated under the Securities Act of 1933 (Rules 134 and 436), the Securities Exchange Act of 1934 (Section 17-H and Rule 10b-6), the Investment Company Act of 1940 (Rules 2a-7, 3a-7 and 10f-3) and under the National Association of Insurance Commissioners Securities Valuation Office).⁵⁵⁰ Since the mid-1970s, statutes and regulations have increasingly come to depend explicitly on NRSRO ratings. In this way, SEC regulations established a *de facto* oligopoly of NRSRO-designated credit rating agencies and an opaque market demand for NRSRO CRAs’ ratings.⁵⁵¹ Institutional investors and many pension funds confined their investments to bonds rated by a NRSRO.⁵⁵²

⁵⁴⁸ Raquel García Alcubilla and Javier Ruiz del Pozo (note 458) 4.

⁵⁴⁹ Lawrence J. White, ‘The Credit Rating Industry: An Industrial Organization Analysis’ in Richard M. Levich, Giovanni Majnoni, and Carmen Reinhart (eds), *Ratings, Rating Agencies and the Global Financial System* (Boston, Mass.: Kluwer Academic Publishing 2002) 305, where the author observes that ‘in essence, the “national recognition” criterion creates a “Catch 22” barrier to entry’; Lawrence J. White, ‘The SEC’s Other Problem’ (2002-2003) *Regulation*, 41. See also Richard Sylla, ‘An Historical Primer on the Business of Credit Rating’ in Richard M. Levich, Giovanni Majnoni, and Carmen Reinhart (eds), *Ratings, Rating Agencies and the Global Financial System* (Boston, Mass.: Kluwer Academic Publishing 2002) 36.

⁵⁵⁰ In the 1930s the first regulator to take notice of credit ratings was the Federal Reserve System which implemented a scheme for evaluating a bank’s entire portfolio based on the credit ratings on the bonds in that portfolio. Subsequently, the US Treasury Department introduced credit ratings as the valuable measure of the quality of a national bank’s bond portfolio.

⁵⁵¹ Until the early 1970s, CRAs mainly earned their income by selling publications and other related materials to investors.

⁵⁵² Anno Stolper, ‘Regulation of credit rating agencies’ (2009) 33 *Journal of Banking & Finance* 7, 1266.

In this context, ratings have been incorporated into government regulation and regulatory tools, but this policy trend had the effect of exacerbating the competitive barriers between rating agencies. The use of ratings in public regulation demonstrated that the ratings industry transcends the purely financial.

These ‘regulatory licenses’ have enabled credit ratings to gain and generate reputational capital among market participants. Reputational capital is usually based on trust and credibility. It represents an essential element of the credit rating activity for two main reasons, namely the decision-making process and assessment accuracy.

From the mid-1970s credit rating agencies switched from their subscriber-pays model to an ‘issuer-pays’ model, determining a substantial change in the core activity of these agencies. Similarly, NRSROs shifted the focus of their business model from investors to issuers and started charging the issuers for the debt they rated. The ‘subscriber-pays’ model relied heavily on the ability to enforce property rights to information that is very easy to disseminate.

The shift from the ‘investor-pays’ to the ‘issuer-pays’ model was largely motivated by the developments in reproduction and distribution technologies that, simultaneously, gave rise to an exacerbation of the free-rider problem. However, the change was also driven by the increasing size and complexity of the securities markets.⁵⁵³

Initially, the SEC’s Division of Market Regulation managed the designation of NRSROs through the issuance of ‘no-action letters’.⁵⁵⁴ If a rating agency wished to be designated as an NRSRO, it sent a letter to the SEC requesting that the SEC recommended no regulatory enforcement action against the rating agency (on the ground that it is designated an NRSRO).⁵⁵⁵ The SEC’s Division of Market Regulation did not develop formal standards for such designation, relying instead primarily on market acceptance of rating agencies in designating NRSROs.

NRSRO status was conferred upon a select few agencies. Such status is important given that obtaining a favourable rating has definitively become a *de facto* prerequisite for any company seeking access to the US financial markets.

⁵⁵³ Lawrence J. White, ‘The Credit Rating Agencies’ (2010) 24 *Journal of Economic Perspectives* 2, 214-215.

⁵⁵⁴ The term ‘no-action letters’ indicates the designation process used by the SEC staff to grant NRSRO status.

⁵⁵⁵ Francis A. Bottini Jr., ‘An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies’ (1993) 30 *San Diego Law Review* 3, 611-612.

This means that the SEC used the NRSRO designation as its ‘seal of approval’ to select on an informal, ‘no-action letter’ basis only a few national credit-rating agencies namely S&P’s, Moody’s Investors Service and Fitch Ratings.⁵⁵⁶

This sort of dependence on ratings favoured regulated financial institutions to engage in regulatory arbitrage. The NRSRO status became a powerful label in attaining reputational capital in the financial markets. The ‘AAA’ ratings became not only a sort of guarantee for investors and regulators, but also a means of exemption from any compliance of disclosure requirements.

NRSRO designation was not a statutory requirement, but a regulatory initiative to specify which ratings could be used to calculate broker-dealers’ required capital.⁵⁵⁷ As has been noted, ‘NRSROs received their designations because of good past performance, not necessarily because of good future performance’.⁵⁵⁸ In this way, regulators insulated the largest NRSROs such as S&P’s, Moody’s and Fitch from competition.

The NRSROs performance and the methodologies used to rate securities assumed great responsibility for regulating the riskiness of investments made by a large number of financial institutions.⁵⁵⁹ Therefore, CRAs were granted regulatory power by the SEC. This has had the effect of making an investment grade rating from a rating agency that was recognized by the SEC a virtual precondition for the purchase of debt securities by many institutional investors.⁵⁶⁰ On this point, it has been observed that ‘rather than government licensing, rating agencies have received market recognition’.⁵⁶¹

In 2005, the SEC published a proposal in which an NRSRO was defined as an entity that (1) issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (2) is generally accepted in the financial markets as an issuer

⁵⁵⁶ Lawrence J. White, ‘A New Law for the Bond Rating Industry-- For Better or For Worse?’, New York University School of Law, Law & Economics Research Paper Series Working Paper No. 07-09, February 2007, 5.

⁵⁵⁷ Alex J. Pollock, ‘End the Government-Sponsored Cartel in Credit Ratings’, in American Enterprise Institute for Public Policy Research, January 2005, 1. The author observes that the SEC limited new entry and competition by mandating demand for rating agency services and severely restricting supply.

⁵⁵⁸ Emily McClintock Ekins and Mark A. Calabria (note 544) 10.

⁵⁵⁹ Erik F. Gerding (note 540) 153.

⁵⁶⁰ John Coffee Jr., ‘What went wrong? An initial inquiry into the causes of the 2008 financial crisis’ (2009) 9 *Journal of Corporate Law Studies* 1, 7.

⁵⁶¹ Jonathan Katz, Emanuel Salinas and Constantinos Stephanou, ‘Credit Rating Agencies’, *The World Bank Group*, October 2009, Note No 8, 2.

of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and (3) uses systematic procedures designed to ensure credible and reliable ratings.⁵⁶²

Although the term ‘NRSRO’ was used in several pieces of legislation⁵⁶³, it was defined for the first time in the Credit Rating Agency Reform Act 2006.⁵⁶⁴ The statute provided authority for the SEC to implement rules regarding the registration, recordkeeping, financial reporting, and oversight of CRAs.⁵⁶⁵

The US legislation does not regulate rating procedures and methodologies because of the imposition of wide disclosure requirements that allows the market to exercise its own judgement when it comes to the quality of credit analysis.⁵⁶⁶ It can be observed that the regulators have an interest in maintaining this regulatory status quo because of CRAs dependent regulation. NRSROs represent an important part of the regulatory process and a crucial determinant of investment strategies.

Indeed, the relevant section of law is clear on regulation entitlement. Section 15E(2) of the 1934 Securities Exchange Act states that ‘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’.

In 2009, the SEC introduced further amendments to rules for NRSROs by prohibiting an NRSRO from issuing or maintaining a rating with respect to an obligor or security where it has made a recommendation to the obligor (or the

⁵⁶² SEC, ‘Definition of Nationally Recognized Statistical Rating Organization’, Release No. 34-51572, 19 April 2005, 20-21.

⁵⁶³ The term ‘NRSRO’ is mentioned in Rule 2a-7 and Rule 3a-7 of the Investment Company Act of 1940; in the definition of “mortgage related security” within the Secondary Mortgage Market Enhancement Act of 1984; in the Simplification of Registration Procedures for Primary Securities Offerings, Securities Act 1992; in Rule 10b-6 of the Securities Exchange Act of 1934; in the Federal Deposit Insurance Act of 1950, section 1831; in the Employee Retirement Income Security Act of 1974; and in the Retirement Income Security Act of 1974.

⁵⁶⁴ Section 3 of the Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327.

⁵⁶⁵ SEC, ‘2012 Summary Report of Commission Staff’s Examinations of Each Nationally Recognized Statistical Rating Organization’, November 2012, 4.

⁵⁶⁶ Committee of European Securities Regulators, ‘Technical Advice to the European Commission on the Equivalence between the US regulatory and supervisory framework and the EU regulatory regime for Credit Rating Agencies’, 21 May 2010, para 603.

issuer, underwriter or sponsor of the security) about the corporate or legal structure, assets, liabilities or activities of the obligor or issuer of the security.⁵⁶⁷

At this stage, it is instructive to draw a comparative analysis between the regulatory systems of the EU and US. The relevance of such an analysis lies in the common objective implemented by the legislators of creating a centralized level of controls for CRAs, that is to say an institutional arrangement that seems in line with the need to establish a more intrusive oversight of the ratings industry. In essence, the strategy of designing specific organisms to deal with the accountability of CRAs can be viewed as a possible way towards coercive financial supervision.

As examined later in this chapter, since 2009 lawmakers in the EU have given regulatory powers to the ESMA as the centralized body in charge of the registration and supervision of rating agencies. ESMA has jurisdiction over the rating agencies that conduct business in the EU, and even exercises regulatory and supervisory powers over the main rating agencies through the subsidiaries that these leading agencies have established in the Union.⁵⁶⁸ In this respect, Véron has observed that although ESMA has been delegated to guarantee regulatory consistency across all EU Member States, the risk of inconsistency or interference with regulatory regimes in non-EU jurisdictions still remains.⁵⁶⁹

The US law adopted a ‘comply or explain’ model, an approach characterized by voluntary compliance and mandatory disclosure mechanisms. Accordingly, ‘companies have the option either to follow the best practices or to explain to their shareholders why they considered that they were not appropriate in the company’s particular circumstances’.⁵⁷⁰ In contrast, European legislation required that information about CRAs should be available for the public at a ‘central repository’ established by ESMA.⁵⁷¹ This ‘central repository’ is a mechanism

⁵⁶⁷ SEC, ‘Amendments to Rules for Nationally Recognized Statistical Rating Organizations’, 4 December 2009, which introduced paragraph 5 of Rule 17-g-5 (c).

⁵⁶⁸ Dorothe Fischer-Appelt, ‘The European Securities and Markets Authority: The Beginnings of a Powerful European Securities Authority?’ (2011) 5 *Law and Financial Markets Review* 1, 23.

⁵⁶⁹ Nicolas Véron, ‘Rate Expectations: What Can and Cannot Be Done about Rating Agencies’ (2011) Bruegel Policy Contribution No 11, 4.

⁵⁷⁰ Financial Reporting Council, ‘What constitutes an explanation under ‘comply or explain’. Report of discussions between companies and investors’, February 2012, 1.

⁵⁷¹ Under the 2013 CRA Regulation, the central repository mechanism should be incorporated by the European Rating Platform.

whereby all registered and certified CRAs make available information on the historical performance of their ratings.⁵⁷²

As Bai has observed, the SEC has followed Europe's lead in establishing a publicly available central repository for standardized data on credit ratings and CRAs' performances.⁵⁷³ It imposes standardization requirements of disclosure, particularly in terms of monitoring and ranking the performance of competing entities in the industry, and making this information available to the public.

The EU and the US share the fundamental notion that by establishing a registration system for CRAs, credit ratings would be used as a valuable reference. This would be beneficial in terms of public regulation as well as provisions to prevent conflicts of interest, disclose information, and retain records.⁵⁷⁴ However, 'further bilateral dialogue on the implementation of the EU regulations is necessary to eliminate the potentially adverse cross-border impact that differing regulatory approaches in the United States and European Union could have on global market participants'.⁵⁷⁵

After considering the main role of the NRSRO system for registering and designating CRAs, the next section provides an analysis of the legislative reforms introduced by the US Credit Rating Agency Reform Act of 2006.

3.2.1 *The Credit Rating Agency Reform Act 2006*

The Credit Rating Agency Reform Act 2006 constitutes the first statutory regulation for credit rating industry in US legislation.⁵⁷⁶ The great part of the Act

⁵⁷² ESMA, 'Annual report on the application of Regulation on credit rating agencies as provided by Article 21(5) and Article 39a of the Regulation (EU) No 1060/2009 as amended by Regulation No 1095/2010', January 2012, 13. The purpose of the central repository is to improve transparency and to contribute to the protection of investors by providing consistent information on the performance of CRAs' ratings.

⁵⁷³ Lynn Bai, 'The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?' (2010) 7 *New York University Journal of Law & Business* 1, 103.

⁵⁷⁴ Takashi Kubota, 'Regulation of Rating Agencies: Current and Future' in Mario Giovanoli and Diego Devos (eds), *International Monetary and Financial Law. The Global Crisis* (Oxford: OUP 2010) 253.

⁵⁷⁵ Kristina St. Charles, 'Regulatory Imperialism: The Worldwide Export of European Regulatory Principles on Credit Rating Agencies' (2010) 19 *Minnesota Journal of International Law*, 401. See also Michael Barnier, 'The Shape of E.U. Financial Regulation and its Impact on the United States and Europe', Speech at The Brookings Institute, Washington, D.C., 3 June 2011 <<http://www.brookings.edu/events/2011/6/03-eu-regulation>> accessed 9 July 2013.

⁵⁷⁶ Prior to the Credit Rating Agency Reform Act of 2006, CRAs had been subject to uneven or limited regulatory oversight by state and federal agencies. The first legislative proposal to avoid the influence of dominant CRAs was the Credit Rating Agency Duopoly Relief Act of 2005. The bill aimed to force the SEC to reduce barriers to entry in the NRSRO market by requiring the

devoted to CRAs seems, at first glance, to be prophetic in view of the fact that this legislative framework was introduced just before the 2007-2009 financial crisis.

As stated in the preamble to the Act, the purpose of the legislation is ‘to improve ratings quality for the protection of investors and is in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry’⁵⁷⁷. The statute mainly regulates conflicts of interest in the ratings industry and aims to improve ratings quality. It aimed to create an objective registration framework through which rating organizations may apply for NRSRO status. In addition, it aimed to facilitate the entry of legitimate agencies that were previously barred from qualification under the former NRSRO designation process.⁵⁷⁸ The legislation was supplemented by the rules on disclosure requirements introduced by the SEC in 2007⁵⁷⁹ and strengthened in 2009.⁵⁸⁰

In 2008, the SEC proposed amendments for NRSROs that were designed to address the ‘opaqueness’ of CRA rating procedures and to reduce undue reliance on credit ratings in the SEC’s regulations and forms.⁵⁸¹

As already mentioned, the Credit Rating Agency Reform Act 2006 defines for the first time the term ‘NRSRO’, but also provides a complete definition of the term ‘credit rating’.⁵⁸² The law provided the SEC with the authority to adopt rules concerning registration, recordkeeping, financial reporting and an oversight programme for credit rating agencies seeking to register as NRSROs.⁵⁸³

One important component of the law was the performance disclosure requirements issued by the SEC. This set of rules was intended to achieve two main goals: (1) to attach reputational damage to CRAs whose ratings are driven by conflicts of interest; and (2) to promote competition by granting new

agency to register NRSROs based on new eligibility criteria, and eliminated the national recognition requirement.

⁵⁷⁷ See the preamble to the Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327.

⁵⁷⁸ Stephane Rousseau, ‘A Question of Credibility: Enhancing the Accountability and Effectiveness of Credit Rating Agencies’, C.D. Institute, Commentary No 356, July 2012, 4.

⁵⁷⁹ SEC, ‘Oversight of Nationally Recognized Statistical Rating Organizations’, June 2007 <<http://www.sec.gov/rules/final/2007/34-55857.pdf>> accessed 19 March 2013.

⁵⁸⁰ SEC, ‘Amendments to the Rules Relating to the Oversight of Nationally Recognized Statistical Rating Organizations’, 2 February 2009 <<http://www.sec.gov/rules/final/2009/34-59342-secg.htm>> accessed 18 March 2013.

⁵⁸¹ F. Phillip Hosp, ‘Problems and Reforms in Mortgage-Backed Securities: Handicapping the Credit Rating Agencies’ (2010) 79 *Mississippi Law Journal* 3, 559.

⁵⁸² Section 3(a) of the Credit Rating Agency Reform Act 2006.

⁵⁸³ The Act gives the SEC ‘exclusive authority to enforce the provisions’ regarding NRSROs, and allows it to amend or review the regulations according to the objectives of the Act.

companies to the ratings industry the chance of building on their track records and ultimately of competing with the main CRAs.

The statute introduced criteria for the NRSRO designation and authorised the SEC to conduct examinations of credit rating agencies, while at the same time prohibiting the SEC from regulating the substance, criteria, or methodologies used in credit rating models.⁵⁸⁴

The Credit Rating Agency Reform Act 2006 added section 15E to the Exchange Act. This established SEC oversight of those credit rating agencies that register with the SEC as NRSROs.⁵⁸⁵ The Credit Rating Agency Reform Act 2006 also amended section 17 of the Exchange Act to provide the SEC with recordkeeping, reporting, and examination authority over registered NRSROs.⁵⁸⁶

Under section 15E, the Credit Rating Agency Reform Act 2006 offered CRAs the option of attaining NRSRO status by registering with the SEC and providing certain information (see 'Appendix III').

In 2007, the SEC adopted Rules 17g-1 to 17g-6 to implement the registration and oversight programme created by the Rating Agency Reform Act.⁵⁸⁷ Under Rule 17g-1 a credit agency could establish eligibility to apply for registration as a NRSRO if the SEC considered it to have satisfied the definitions for CRA and 'NRSRO' under the Credit Rating Agency Reform Act 2006.

Under Rule 17g-2 an NRSRO is required to make and keep certain records relating to its business and to preserve those and other records for certain prescribed time periods. Rule 17g-3 requires each NRSRO to furnish audited annual financial statements and certain schedules to the SEC.

Rule 17g-4 requires an NRSRO to establish, maintain and enforce written policies and procedures to prevent the misuse of material, non-public information in violation of the Exchange Act (policies designed to prevent the inappropriate dissemination both inside and outside the NRSRO of material non-public information obtained for the purpose of issuing a credit rating).

⁵⁸⁴ Sections 15E(c)(2) and 17(a)(1) of the Securities Exchange Act of 1934, as amended by the Credit Rating Agency Reform Act of 2006. See also United States Senate Permanent Subcommittee on Investigations, 'Wall Street and the Financial Crisis: Anatomy of a Financial Collapse', 13 April 2011, 27-28.

⁵⁸⁵ SEC, 'Section 15E of the Securities Exchange Act of 1934, as amended by the Dodd-Frank Act' <<https://www.sec.gov/divisions/marketreg/ratingagency.htm>> accessed 17 March 2013.

⁵⁸⁶ Sections 17(a) and 17(b) of the Credit Rating Agency Reform Act 2006.

⁵⁸⁷ SEC (note 579).

Under Rule 17g-5 an NRSRO is required to establish and maintain an adequate structure of internal management in order to address any conflicts of interest in the CRAs' business model. Finally, Rule 17g-6 addresses unfair, coercive, or abusive practices determined by the NRSRO and prohibits the NRSRO from issuing 'unsolicited credit ratings'.

The SEC provisions prohibited an NRSRO from having certain conflicts of interest and engaging in certain unfair, abusive, or otherwise coercive practices. Specifically, the rules addressed conflicts of interest at both the rating analyst level and the rating agency level.

At the rating analyst level, the SEC put a stop to the conflicts that arise from certain arrangements. These include: analysts owning the securities subject to their rating; holding directorship or employment positions at the rated entities; maintaining special personal or business relationships with the rated entities; receiving gifts from the securities entities, and being compensated based on the rating fees that they help generate for the rating agencies that employ them.

Similarly, at the rating agency level, the SEC regulated conflicts that arise from rating agencies' receiving compensation for their ratings from the rated entities, providing consulting and other ancillary services to the rated entities, rating securities issued or underwritten by affiliated entities, and receiving subscription fees from financial institutions whose asset portfolios include securities subject to the rating agencies' ratings.⁵⁸⁸

The SEC amended several of these rules in 2009 with the purpose of further increasing the transparency of NRSRO rating methodologies, strengthening the disclosures of rating performance, prohibiting NRSROs from engaging in certain unfair, coercive, or abusive practices, and enhancing NRSRO record-keeping.⁵⁸⁹

However, according to section 15E of the Credit Rating Agency Reform Act 2006, the SEC does not have the power to regulate the substance of credit ratings or the procedures or methodologies by which an NRSRO determines credit ratings.⁵⁹⁰

⁵⁸⁸ Lynn Bai (note 293) 55.

⁵⁸⁹ SEC (note 579). In November 2009, SEC adopted new provisions on rating disclosure in order to: (1) facilitate ratings-by-ratings comparisons across CRAs; and (2) generate data that can be used to develop independent statistical analyses of the overall performance of a CRA in total and for each class and subclass of credit ratings.

⁵⁹⁰ The Credit Rating Agency Reform Act 2006 ensured that neither the SEC nor the state could regulate credit ratings' content, procedures, or methodologies, and prohibited NRSROs from

Although the Credit Rating Agency Reform Act 2006 strengthened oversight of the CRAs by promoting transparency, the legislation only attempted to improve the designation process by replacing the artificial barriers created by the SEC approval system and by increasing investor confidence with high quality ratings and lower costs.

Despite the fact that a primary result of the legislation was to reduce arbitrary SEC power to designate NRSROs and instead set timelines for SEC response, the statute can be considered to be a compromise in a number of ways. The SEC did not have the authority to regulate the substance of ratings or how NRSROs determine ratings. The Credit Rating Agency Reform Act 2006 did not attempt to register *all* credit rating agencies but instead, ‘sought only to convey special status on those credit rating agencies that are nationally recognized’.⁵⁹¹

In addition, the Credit Rating Agency Reform Act 2006 did not give secondary agency examination authority to federal banking agencies to verify the integrity of credit ratings assigned to investment-grade securities purchased by depository institutions.⁵⁹²

The 2007-2009 financial crisis demonstrated the inadequacy of the SEC powers to regulate CRAs in order to improve the quality of ratings and underlined the essential weaknesses of 2006 legislation.

With the Credit Rating Agency Reform Act 2006, the narrow structure of the credit rating industry has not changed significantly in the US. After the SEC revised its regulations for the designation of NRSROs in 2007 and 2009, the dominance of S&P’s, Moody’s and Fitch remained unaffected and made it difficult for new CRAs to qualify as NRSROs. While competition may improve the quality of ratings, it is doubtful that the entry of new CRAs alone will resolve the problem of poor ratings.⁵⁹³

The US legislation proposed further reforms in response to the financial turmoil, namely the Restoring American Financial Stability Act of 2009⁵⁹⁴, yet it

allowing conflicts of interest to impact rating integrity.

⁵⁹¹ Elliott R. Curzon, Stuart J. Kaswell and Alan Rosenblat, ‘SEC Proposes Rules for Registration of Credit Rating Agencies’ (2007) 124 *The Banking Law Journal* 5, 451.

⁵⁹² Melissa L. Richards, ‘Credit Rating Agency’ *Mortgage Banking*, April 2009, 42.

⁵⁹³ Yair Listokin and Benjamin Taibleson, ‘If You Misrate, Then You Lose: Improving Credit Rating Accuracy through Incentive Compensation’ (2010) 27 *The Yale Journal on Regulation* 1, 101.

⁵⁹⁴ See Restoring American Financial Stability Act of 2009, draft legislation released by the Senate Banking Committee. Following the adoption of Dodd-Frank Act 2010, the draft legislation was

only sought to restore confidence in rating agencies.⁵⁹⁵ However, the recent legislation for CRAs revealed that Regulations' use of NRSRO designations still remains the major issue with regard to ratings reliance.

The next section examines the major regulatory developments introduced by the US legislature, and most particularly, the Dodd-Frank Act 2010.

3.2.2 *The Dodd-Frank Act 2010*

Following the subprime mortgage crisis, the US legislators enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ('Dodd-Frank Act')⁵⁹⁶. This legislation introduced specific rules, sections 931-939H, aimed at improving the regulation of CRAs.⁵⁹⁷

The Dodd-Frank Act broadened the powers of the SEC to oversee and regulate the credit rating industry and explicitly allowed investors, for the first time, to file civil suits against credit rating agencies. In particular, the statute imposes new self-executing requirements with respect to credit rating agencies registered with the SEC as NRSROs and requires that the Commission adopt rules applicable to NRSROs in a number of areas.⁵⁹⁸

According to section 931(2) of the Dodd-Frank Act, credit rating agencies, including NRSROs, play a critical 'gatekeeper' role in the debt market that is functionally similar to that of securities analysts. The latter includes those who evaluate the quality of securities in the equity market, and auditors, who review the financial statements of firms.

The main changes introduced by sections 931-939H of the Dodd-Frank Act focus on: (1) the new SEC Office of Credit Ratings charged with overseeing the

enacted by the Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Congress (2009-2010).

⁵⁹⁵ Mahesh Kotecha, Sharon Ryan and Roy Weinberger, 'The Future of Structured Finance Ratings After the Financial Crisis' (2010) 15 *The Journal of Structured Finance* 4, 68. The author observes that 'confidence in rating agencies will be restored only if they are paid neither by the sell side nor the buy side but by both'.

⁵⁹⁶ On July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203.

⁵⁹⁷ Title IX, Subtitle C of the Dodd-Frank Act "Improvements to the Regulation of Credit Rating Agencies".

⁵⁹⁸ SEC, 'Report to Congress Credit Rating Standardization Study. As Required by section 939(h) of the Dodd-Frank Wall Street Reform and the Consumer Protection Act', September 2012, 1. The Act gave the SEC broad powers to register and regulate credit rating agencies, and included mandates for improving internal controls, reducing conflicts of interest, and increasing public disclosure.

credit rating industry; (2) SEC authority to discipline, fine, and deregister a CRA and associated personnel for violating the law; (3) authority for investors to file private causes of action against credit rating agencies that knowingly or recklessly fail to conduct a reasonable investigation of a rated product; (4) requirements for credit rating agencies to establish internal controls to ensure high quality ratings and disclose information about their rating methodologies and about each issued rating; and (5) amendments to federal statutes removing references to credit ratings and credit rating agencies in order to reduce reliance on ratings.

With respect to oversight, the legislation establishes a new regulatory body, namely the Office of Credit Ratings with the power to regulate rating agency activities including disclosure, conflicts of interest and rating criteria. The creation of this new body within the SEC conveys a strong message of following through more effective supervision of the ratings industry.⁵⁹⁹

With respect to accountability, the Dodd-Frank Act includes limited provisions that would make rating agencies liable for their wrongdoings. In addition, the law requires the removal of many rating-based regulations in order to reduce an over-reliance on ratings for both regulatory and behavioural purposes.⁶⁰⁰ The statute seeks to reduce such over-reliance on CRAs by removing the statutory references to credit ratings and by removing the terms ‘investment grade’ and ‘non-investment grade’ in order to make clear the standards of creditworthiness.⁶⁰¹

It is hoped that the removal of regulatory reliance on ratings will stimulate legislators to find appropriate substitutes for ratings and to enhance due diligence by investors. Regulators should seek to find alternative measures to evaluate credit risk in order to reduce private reliance on ratings and stimulate the use of quantitative (credit spreads or Credit Default Swap spreads)⁶⁰² and qualitative substitutes (based on professional judgement).

⁵⁹⁹ Section 932(a)(8) of the Dodd-Frank Act.

⁶⁰⁰ Aline Darbellay and Frank Partnoy, ‘Credit Rating Agencies under the Dodd-Frank Act’ (2011) 30 *Banking & Financial Services Policy Report* 12, 1.

⁶⁰¹ Section 939 of the Dodd-Frank Act. Although the Act does not require the private sector to eliminate references to ratings, this provision represents a significant regulatory change with regard to the concern about over-reliance on ratings.

⁶⁰² Frank Partnoy, ‘The Siskel and Ebert of Financial Markets?’ Two Thumbs Down for the Credit Rating Agencies’ (1999) 77 *Washington University Law Quarterly* 3, 619. See also Mark J. Flannery, Joel F. Houston and Frank Partnoy, ‘Credit Default Swap Spreads As Viable Substitutes for Credit Ratings’ (2010) 158 *University of Pennsylvania Law Review* 7, 2089.

Some scholars argue that the ‘rolling averages of market prices at least potentially reflect a wider range of available information than ratings, and may be a more timely and accurate measure of credit risk’.⁶⁰³ Such a regulatory approach reflects the policy to address the systemic effects of ratings, particularly within the structured finance sector where CRAs have access to private information on their underlying assets.⁶⁰⁴

In 2011, the SEC adopted Rule 17g-7, which requires NRSROs to include information regarding the representations, warranties and enforcement mechanisms available to investors in any asset-backed securities offering. This information should be included in any report accompanying a credit rating issued in connection with such an offering, including a preliminary credit rating.⁶⁰⁵

The Dodd-Frank Act introduced under Section 939F a ‘Study’ on: (1) the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models; and (2) the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine the credit ratings of structured finance products.

Although the feasibility of this study must be tested, the Dodd-Frank Act specifically calls for a system for the assignment of NRSROs to determine the initial credit ratings of structured finance products. This is to be done in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product from selecting the NRSRO that will determine the initial credit ratings and monitor such credit ratings.⁶⁰⁶

These measures are intended not only to avoid an over-reliance on ratings, but also to replace the NRSRO certification process and its regulatory privileges. However, behavioural reliance on ratings has been deeply anchored in the securities markets. Excluding references to ratings in regulations does not mean that ratings will not be used by private parties.⁶⁰⁷

⁶⁰³ Aline Darbellay and Frank Partnoy (note 632) 8.

⁶⁰⁴ Title IX, Subtitle D of the Dodd-Frank Act “Improvements to the Asset-Backed Securitization Process”.

⁶⁰⁵ SEC, Release No. 33-9175, 20 January 2011, 76 FR 4489, 26 January 2011.

⁶⁰⁶ Title IX, Subtitle C, section 939F “Study and Rulemaking on Assigned Credit Ratings”.

⁶⁰⁷ Jin-Chuan Duan and Elisabeth Van Laere, ‘A public good approach to credit ratings – From concept to reality’ (2012) 36 *Journal of Banking & Finance* 12, 3242.

The question at stake is whether investors stop relying on ratings even if regulatory reference to ratings is definitively removed. A possible answer lies in the implementation of credible alternative sources of credit information that investors can trust in and stimulate competitive pressure on CRAs.

Most importantly, the Dodd-Frank Act empowers the SEC to bar NRSROs in the event of serious shortcomings in how they rate. According to section 932(a)(3)(I) ‘the Commission may temporarily suspend or permanently revoke the registration of a NRSRO with respect to a particular class or subclass of securities, if the Commission finds, on the record after notice and opportunity for hearing, that the NRSRO does not have adequate financial and managerial resources to consistently produce credit ratings with integrity’. This rule marks a significant change in ratings governance because, for the first time, NRSROs have to disclose their rating performance through reports to the SEC that must be made available to the public as well. NRSROs are similarly required to establish effective internal control structures for the improvement of ratings procedures and methodologies.⁶⁰⁸

Pursuant to section 932(q)(2) of the Dodd-Frank Act, the NRSRO is required to submit an attestation in which it is affirmed that no part of the rating was influenced by any other business activities. It must also confirm that the rating was based solely on the merits of the instruments being rated, and that such a rating was an independent evaluation of the risks and merits of the instrument.

Regarding the ratings’ symbols, section 938(a) of the Dodd-Frank Act states that NRSROs have to: (1) assess the probability of whether an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money-market instrument; (2) define and disclose the meaning of any symbol used by the nationally recognised statistical rating organization to denote a credit rating; and (3) apply any symbol in a manner that is consistent for all types of securities and money-market instruments for which the symbol is used.

Regarding civil liability, the Dodd-Frank Act creates a new regime in which issuers have to obtain permission from NRSROs to use their ratings in their

⁶⁰⁸ The Act reinforces the importance of the compliance function (provided in section 15E(j) of the 2006 Credit Rating Agency Reform Act) in the NRSRO governance as a deterrence of misconduct and inflated ratings.

prospectuses and NRSROs are subject to the same standards as public accountants and securities analysts.⁶⁰⁹

NRSROs are liable as experts under the Securities Act of 1933 when they consent to the disclosure of their ratings in a prospectus.⁶¹⁰ This means that rating agencies are no longer exempt on First Amendment defences from the private right of action.⁶¹¹ It has been argued that ‘holding the NRSROs accountable for their errors introduces the notion of legal liability that imposes considerable costs on the system by frivolous and unfair lawsuits’.⁶¹²

Therefore, the major change brought in by the Dodd-Frank Act is that of viewing CRAs as financial gatekeepers with the same standards of accountability and liability as other intermediaries, such as security analysts, investment bankers and auditors.

Although the Dodd-Frank Act provides a more stringent regulatory regime for CRAs, closer examination of the text reveals some gaps with respect to the problem of incentive misalignment in the ‘issuer-pays’ model. In addition, the Act does not provide any rules to address the thorny issue of conflicts of interest.⁶¹³

Under section 931(4) of the Dodd-Frank Act, the legislation merely alludes to conflict of interest concern. It states that in advising arrangers of structured financial products about the potential ratings of such products, credit rating agencies face conflicts of interest that need to be carefully monitored. Looking at section 932(a)(8) of the Dodd-Frank Act, the statute provides that the Office of Credit Ratings is entitled to ensure that NRSROs’ ratings are not unduly influenced by conflicts of interest. These rules demonstrate the ‘light touch’

⁶⁰⁹ Stephane Rousseau (note 578) 12.

⁶¹⁰ Section 12 of the Securities Act of 1933, 48 Stat. 84. In 1982, SEC adopted Rule 436(g), which specifically eliminated liability for the big CRAs, namely Moody’s, Standard & Poor’s, Fitch’s and Duff and Phelps, as “experts” under sections 7 and 11 of the Securities Act of 1933. Section 939G of the Dodd-Frank Act repeals SEC rule 436(g).

For a scholarly commentary, see Marilyn Blumberg Cane, Adam Shamir and Tomas Jodar, ‘Below Investment Grade and Above the Law: A Past, Present and Future Look at the Accountability of Credit Rating Agencies’ (2012) 17 *Fordham Journal of Corporate & Financial Law* 4, 1080-1084.

⁶¹¹ According to Section 933 of the Dodd-Frank Act 2010, the enforcement and penalty provisions of the Securities and Exchange Act of 1934 are applicable to NRSRO statements.

⁶¹² Edward I. Altman, T. Sabri Oncu, Matthew Richardson, Anjolein Schmeits and Lawrence J. White, ‘Regulation of Rating Agencies’ in Viral V. Acharya, Thomas F. Cooley, Matthew Richardson and Ingo Walter (eds) *Regulating Wall Street. The Dodd-Frank Act and the New Architecture of Global Finance* (New York: John Wiley & Sons, Inc. 2011) 458.

⁶¹³ John C. Coffee Jr., ‘The political economy of Dodd-Frank: Why financial reform tends to be frustrated and systemic risk perpetuated’ in Eilís Ferran, Niamh Moloney, Jennifer G. Hill, John C. Coffee, Jr (eds), *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge: CUP 2012) 368 (footnote 250).

approach of the Dodd-Frank Act in dealing with the regulation of the CRAs' business model. The monitoring of conflicts of interest is mandated to the internal management of the NRSROs (i.e. the board of directors), which only has a duty to oversee the possible conflicts.⁶¹⁴

Another concern that arises from the legislation regards the lack of specific provisions on sovereign debt ratings. The 2011-2012 Greek crisis has shown how important it is to pay specific attention to sovereign debt assessment and the consistency of ratings.⁶¹⁵ McNamara noted that 'while the Dodd-Frank Act contains important reforms meant to reduce the likelihood of future ratings failure, it does not attempt to regulate the ratings process directly but instead relies on the traditional securities law strategies of disclosure and liability to incentivize the production of accurate ratings'.⁶¹⁶

On the one hand, the Dodd-Frank Act does introduce some significant improvements to the CRAs' activities, on the other hand it seems to impose heavy oversight and burdensome rules in an attempt to reduce the NRSRO's role and increase SEC supervision.⁶¹⁷ In essence, the Dodd-Frank Act does not lay down a specific norm regarding enforcement. However, it does delegate this function to compliance, which has to monitor management behaviours and create strong incentives to reduce the risk of confidence failures. It is possible to conclude that the reform attempts to secure ratings transparency through strong supervisory measures, but completely leaves to the firm's internal controls the role of monitoring CRAs' activities.

After providing an analysis of the Dodd-Frank Act, the next section considers the UK regulatory treatment of CRAs taking into account the main features of the UK approach to the role of CRAs.

⁶¹⁴ Section 932(t) (3) of the Dodd-Frank Act provides that that the duties of an NRSRO's Board of Directors are 'the establishment, maintenance, and enforcement of policies and procedures to address, manage, and disclose any conflicts of interest'.

⁶¹⁵ Rabah Arezki, Bertrand Candelon and Amadou N. R. Sy, 'Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis', IMF Working Paper No 68, March 2011, 20.

⁶¹⁶ Steven McNamara, 'Informational Failures in Structured Finance and Dodd-Frank's "Improvements to the Regulation of Credit Rating Agencies"' (2012) 17 *Fordham Journal of Corporate & Financial Law* 3, 665.

⁶¹⁷ Edward I. Altman, T. Sabri Oncu, Matthew Richardson, Anjolein Schmeits and Lawrence J. White (note 644) 444.

3.3 *The UK approach to the role of CRAs*

As has been already indicated, the regulatory system for CRAs has proved ineffective in addressing the shortcomings associated with rating activities.⁶¹⁸ The normative measures adopted by regulators and lawmakers have raised a number of concerns when it comes to their actual capacity to oversee CRAs.⁶¹⁹

Although rating agencies have become the arbiters of government debt, being involved in securities regulation and investment decisions, they have still not been regulated effectively worldwide.⁶²⁰ It is remarkable, too, that ‘regulators have sought to harness the claimed informational value attached to ratings by enrolling CRAs as surrogate regulators’.⁶²¹ Unlike other financial gatekeepers—such as auditors, accounting firms, and underwriters—CRAs are used for regulatory purposes because of their reputation as evaluators of the creditworthiness of financial products. This has enabled CRAs to become an integral part of capital markets ‘as both endogenous and exogenous actors’.⁶²²

The 2007-2009 financial crisis revealed both the huge reliance that had been made on ratings performance and the substantial failure of regulatory schemes established at regional and international levels. On the one hand, financial regulation failed both to contain the systemic risk posed by inaccurate ratings and to avoid the persistent conflicts of interest arising between agencies and issuers. On the other hand, market discipline was not capable of reconciling private interests with the public good.⁶²³

As discussed earlier in this chapter, the normative response adopted by many countries mainly followed the recommendations set out by the global regulatory network (IOSCO, FSB, G-20, BCBS and IMF). IOSCO provided soft-law mechanisms and self-regulatory measures in order to enhance the transparency of

⁶¹⁸ Thomas J. Fitzpatrick IV and Chris Sagers, ‘Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations’ (2009) 61 *Administrative Law Review*, 564-565; David J. Reiss, ‘Rating Agencies: Facilitators of Predatory Lending in the Subprime Market’ in Robert W. Kolb (ed), *Lessons from the Financial Crisis. Causes, Consequences, and Our Economic Future* (New York: Wiley & Sons Ltd. 2010) 191.

⁶¹⁹ James M. Garner, ‘The EU and US Attempts to Regulate Credit Rating Agencies Following the 2008 Global Financial Crisis’ (2013) 16 *Financial Regulation International* 2, 7-8.

⁶²⁰ Takashi Kubota (note 574) 252.

⁶²¹ Harry McVea, ‘Credit Rating Agencies’, Written Evidence, House of Commons, Treasury Committee, February 2012, 4.

⁶²² Chris Brummer and Rachel Loko (note 487) 154.

⁶²³ Jin-Chuan Duan and Elisabeth Van Laere (note 607) 3239.

CRAs.⁶²⁴ National regulators implemented various reforms in order to design an adequate legal framework for CRAs—reforms that were especially focused on registration, methodology disclosure, and supervision. However, the question at stake is whether these strategies provided an adequate response to the growing role of CRAs in the financial markets.

In 2012, the House of Commons underlined the need for increased regulation of CRAs by affirming that effective supervision combined with adequate enforcement represents a viable route to strengthen the regulatory regime for rating agencies.⁶²⁵ The value of increasing regulation and improving the transparency of CRAs constitute major issues that legislators and policymakers have attempted to resolve in order to restore investors' confidence in ratings.

In the UK, regulators and legislators adopted a mixed system of principles and rules for CRAs. This regulatory approach has been mainly influenced by EU law and international initiatives.⁶²⁶

The legislature passed the “Credit Rating Agencies Regulations 2010” in order to incorporate European Regulation (EC) No 1060/2009 on CRAs⁶²⁷ into UK law and ensure that the European law was fully effective and enforceable within domestic legislation.⁶²⁸

The “Credit Rating Regulations 2010” designated the former FSA—today the Financial Conduct Authority (FCA)—as the competent authority in the UK for the purposes of the European Regulation.⁶²⁹ More specifically, the ‘Credit Rating Regulations 2010’: (1) contained provisions relating to applications for certification and registration; (2) vested investigatory powers in the FSA; (3) provided enforcement powers for the FSA to take action where a CRA breaches obligations arising under the EU Regulation; (4) created penalties and offences

⁶²⁴ IOSCO (note 523).

⁶²⁵ House of Commons, Treasury Committee, ‘Credit Rating Agencies’, Written Evidence, February 2012, 70-71.

⁶²⁶ Siegfried Utzig, ‘The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective’, Asian Development Bank Institute Working Paper Series No 188, January 2010, 7.

⁶²⁷ Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (OJ 2009 L 302, p. 1).

⁶²⁸ Regulation 6 of the Credit Rating Agencies Regulations 2010 (SI 2010/906). The ‘Credit Rating Regulations’ came into force on 7 June 2010. The EU regulation had direct application in the UK to credit rating agencies falling within its scope, certain types of regulated entity and relevant competent authorities.

⁶²⁹ The benefits of designating the former FSA as the competent authority and drawing upon an established enforcement process, penalties, and appeal was that it gave legal and regulatory certainty to CRAs who will then be dealing with a well established body and enforcement regime.

which may apply if a person breaches a requirement of the EU Regulation or the Credit Rating Regulations; (5) made provisions for appeals; (6) provided for notices; and (7) made consequential changes to the Capital Requirements Regulations 2006.

Following the adoption of EU Regulation No 513/2011⁶³⁰, the UK Government issued the “Credit Rating Agencies (Amendment) Regulations 2011”. The legislation reviewed the Credit Rating Agency Regulations 2010 in order to reflect the transfer of regulatory responsibility to the ESMA.⁶³¹

Consequently, Regulation (EU) No 462/2013⁶³² has been implemented in the UK legislation by the “Credit Rating Agencies (Civil Liability) Regulations 2013”⁶³³. The Act strengthens the responsibility regime of CRAs by implementing Article 35a of Regulation No 1060/2009 that provides for the civil liability of credit rating agencies ‘when an agency, either intentionally or with gross negligence, commits any of the infringements listed in Annex III to the EC Regulation’ (further discussion of the civil liability regime is provided in Chapter five).⁶³⁴

Competent national authorities such as the FCA play a key role in the supervision of credit rating agencies and work collaboratively with ESMA.⁶³⁵ It should be noted that with the new financial supervisory structure introduced following the deliberations of the ‘de Larosière Group’⁶³⁶, the FSA’s role in relation to the supervision of CRAs was subordinated to ESMA.⁶³⁷ Although the

⁶³⁰ Regulation (EC) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies (OJ 2011 L 145, p. 30).

⁶³¹ “Explanatory Memorandum to the Credit Rating Agencies (Amendment) Regulations 2011 (2011 No 1435)”.

⁶³² Regulation (EU) No 462/2013.

⁶³³ Credit Rating Agencies (Civil Liability) Regulations 2013 (SI 2013/1637), 25 July 2013.

⁶³⁴ “Explanatory Note to the Credit Rating Agencies (Civil Liability) Regulations 2013 (2013 No 1637)”, 3 July 2013.

⁶³⁵ The Credit Rating Agencies (Amendment) Regulations 2011 revoked provisions of the Credit Rating Agencies Regulations 2010, enable ESMA to enforce in the United Kingdom any sanctions and periodic penalties it might impose under EU Regulation No 513/2011, and required ESMA to obtain authorization from the High Court before requesting records of telephone or data traffic, or carrying out an on-site inspection.

⁶³⁶ The High-Level Group on Financial Supervision in the EU chaired by Jacques de Larosière, Report, Brussels, 25 February 2009.

⁶³⁷ As proposed by the de Larosière Report, ESMA replaced the Committee of European Securities Regulators when it comes to the main function of the registration and supervision of ratings agencies. See Niamh Moloney, ‘The European Securities and Markets Authority and institutional design for the EU financial market - a tale of two competences: Part 1: rule-making’ (2011) 12 *European Business Organization Law Review* 1, 43-45; Niamh Moloney, ‘The European Securities and Markets Authority and Institutional Design for the EU Financial Market - A Tale of

supervising of firms in the UK remains the responsibility of the FCA, CRAs are now supervised by ESMA. The FCA liaises closely with ESMA and the other Member States to monitor the risk of failures of CRAs and mitigate them appropriately.⁶³⁸

As discussed, UK legislation for CRAs follows the regulatory schemes adopted at both European and international levels; in particular the UK follows the three CRA Regulations, which, when level 2 is considered, leave almost no discretion to the Member States. In this context it is useful to note that the Turner Review made a significant shift in the approach to the regulation of the UK financial and banking sector.⁶³⁹ The document was issued by the FSA in 2009 as a response to the widening financial crisis and the implications of bank collapses such as Northern Rock, Bear Stearns, Royal Bank of Scotland and Halifax Bank of Scotland.⁶⁴⁰

The Turner Review was published to provide the first, in-depth response to the evident gaps in banking supervision. Its recommendations were based on a macro-prudential approach rather than focusing solely on specific firms.⁶⁴¹

After providing a brief overview of the UK regulatory framework for CRAs, the following section analyses the Turner Review in detail and its effects on the ratings market. It takes into consideration the role of the supervisory authorities and the potential reforms for strengthening the CRAs' activities.

Two Competences: Part (2) Rules in Action' (2011) 12 *European Business Organization Law Review* 2, 179-180. See also Eilís Ferran, 'Financial Supervision' in Daniel Mügge (ed.), *Europe and the Governance of Global Finance* (Oxford: OUP 2014) 33-34.

⁶³⁸ House of Commons, Treasury Select Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City. Ninth Report of Session 2008-09', 12 May 2009, 36-37.

⁶³⁹ FSA, 'The Turner Review. A Regulatory Response to the Global Banking Crisis', March 2009, 2 and 18-20. See also Iain MacNeil and Justin O'Brien, 'Introduction: The Future of Financial Regulation' in Iain MacNeil and Justin O'Brien (eds), *The Future of Financial Regulation* (Oxford and Portland, Oregon: Hart Publishing 2010) 10 and 19-20; Iain MacNeil, 'The Trajectory of Regulatory Reform in the UK in the Wake of the Financial Crisis' (2010) 11 *European Business Organization Law Review* 4, 497-499.

⁶⁴⁰ See Eilís Ferran, 'Crisis-driven regulatory reform: where in the world is the EU going?' in Eilís Ferran, Niamh Moloney, Jennifer G. Hill, John C. Coffee, Jr (eds), *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge: CUP 2012) 24-25. See also Clare Chambers, 'The Turner Review: A Verbose Attempt at Curbing the Cycle' (2009) 30 *Business Law Review* 7, 158; Simon Crown, 'Turner Review and its Impact on the Future of Banking' (2009) 24 *Butterworths Journal of International Banking and Financial Law* 5, 243; Stephen Platt, 'Why Turner Got it Wrong' (2009) (June) *Compliance Monitor* 1.

⁶⁴¹ Iain MacNeil, 'The Trajectory of Regulatory Reform in the UK in the Wake of the Financial Crisis' (note 639) 487.

3.3.1 *The FSA 2009 Turner Review: the self-regulation regime*

The FSA's Turner Review can be regarded as the first concrete regulatory response to the shortcomings of CRAs.⁶⁴² The Review constituted an important contribution to the governance of CRAs and a significant step in the development of greater accountability of ratings. In the Review, the FSA made clear its conviction that regulatory change was required in order to improve the 'governance and conduct of rating agencies and the management of conflicts of interest'.⁶⁴³ It contains a set of recommendations regarding the transparency of rating methodologies and the integrity of CRAs.

The former Chief Executive of the FSA, Hector Sants, affirmed that 'credit ratings have become very deeply embedded in the regulatory architecture, so when they change they have knock-on effects across the board in terms of the way companies can fund themselves'.⁶⁴⁴

In a scholarly commentary, it has been noted that the embodiment of ratings in regulation has automatic effects on the likelihood for securities and their issuers to find a sort of quasi-public licence that affects the success of an issue.⁶⁴⁵

The Review called for closer supervision of credit rating agencies. In particular, it recommended that: (1) CRAs should be subject to registration and supervision to ensure good governance and management of conflicts of interest and to ensure that credit ratings are applied only to securities for which a consistent rating is possible; (2) CRAs and regulators should ensure that communications to investors about the appropriate use of ratings make it clear they are designed to carry inference for credit risk, not liquidity or market price; and (3) there should be a fundamental review of the use of structured finance ratings in the Basel II framework.

The Review proposed a new type of regulatory regime, namely a principles-based one.⁶⁴⁶ Such a regime was to be the cornerstone of the UK securities market and meant 'moving away from reliance on detailed, prescriptive rules and relying

⁶⁴² FSA (note 639) 76-79.

⁶⁴³ *ibid* 78.

⁶⁴⁴ House of Commons (note 638) 74. Mr Sants pointed out that 'the FSA did not have a national remit to take the regulation of CRAs forward locally because they are not based here' (at 75).

⁶⁴⁵ Donato Masciandaro, 'What if Credit Rating Agencies Were Downgraded? Ratings, Sovereign Debt and Financial Market Volatility' (2011) 46 *Intereconomics* 5, 257.

⁶⁴⁶ The principles-based regime consists of a set of second-level norms, such as standards, guidance, voluntary codes, ethical and moral values and best practices enhancing forms of self-induced legislation.

more on high-level, broadly stated rules or principles to set the standards by which regulated firms must conduct business'.⁶⁴⁷

As affirmed in the Review, this regulatory regime involved: (1) a radical shift in supervisory style from focusing on systems and processes to focusing on key business outcomes and risks and on the sustainability of business models and strategies; (2) a different approach to the assessment of approved persons, with a focus on technical skills as well as probity; and (3) an outstanding increase in resources devoted to sectoral and firm comparator analysis, enabling the FSA to identify more effectively firms which are outliers in terms of risks and business strategies and to identify emerging sector-wide trends which may create systemic risk.⁶⁴⁸

However, the principles-based regime as a pre-crisis approach proved to have limits and weaknesses.⁶⁴⁹ The most important aspect had to do with the legitimacy of this regime as a regulatory strategy. A principle in itself does not ensure a correct application of rules because, often, it is synonymous with escaping enforcement and a lack of certainty.⁶⁵⁰ In this respect, it has been observed that 'a principles-based approach does not work with individuals who have no principles'.⁶⁵¹

The principles-based regime needs internal controls to strengthen its enforcement and must be accepted by market participants as a voluntary, yet binding, legal regime.⁶⁵² It is arguable that principles represent a form of soft law, albeit not readily translatable into a legal paradigm of reference.

Adopting principles-based regulation does not mean jettisoning the rules. It gives legislatures the power to set high-level regulatory goals and outcomes, and leaves the articulation of processes and details to front-line regulators in

⁶⁴⁷ Julia Black, Martin Hopper and Christa Band, 'Making a Success of Principles-based Regulation' (2007) 1 *Law and Financial Markets Review* 3, 191.

⁶⁴⁸ FSA (note 639) 88-92.

⁶⁴⁹ Julia Black, 'Paradoxes and Failures: "New Governance" Techniques and the Financial Crisis' (2012) 75 *The Modern Law Review*, 1042-1045.

⁶⁵⁰ Julia Black, 'Using Rules Effectively' in Christopher McCrudden (ed.), *Regulation and Deregulation* (Oxford: OUP 1998) 101.

⁶⁵¹ Peter Thal Larsen and Jennifer Hughes, 'Sants signals more muscular regulatory era', *Financial Times* (London, 13 March 2009) 19. In particular, Sants pointed to the fragility of the 'light touch' approach, while announcing more intensive supervision characterized by macro-prudential and sector analysis.

⁶⁵² Julia Black (note 534) 4-5.

collaboration with the industry itself.⁶⁵³ Therefore, a principles-based regime can be considered a form of self-regulation in which the markets can be regarded as rule-makers and governance rules as a surrogate for statutory norms.⁶⁵⁴

In this context, the positive aspects of implementing self-regulatory measures in the ratings industry are speed, cost-efficiency and, more importantly, acceptance and cross-border application. However, to bring about these benefits, self-regulation needs to be properly integrated into the overall normative framework and must have adequate and effective enforcement regimes.⁶⁵⁵

As Yeoh argued, ‘self-regulation in the credit rating industry evolved to forestall regulatory intervention, as a compromise for deregulatory weaknesses when quality or integrity issues pertaining to industry practices begin to surface in the early 1970s’.⁶⁵⁶

As indicated above, the FSA’s Turner Report proposed a set of guidelines in order to reduce the inappropriate use of ratings and to secure financial soundness. But the regulatory improvements put forward in the FSA’s recommendations are debatable as to whether they indeed, are ‘improvements’. Government regulations often have the unintended and negative consequence of creating an insufficient normative framework for addressing the major concerns about the ratings industry. It has been a ‘game of cat and mouse’ between the rating agencies and regulators in a global context whereby regulators have pursued them for their role in the recent sovereign debt crisis.⁶⁵⁷

⁶⁵³ Cristie Ford, ‘Principles-Based Securities Regulation in the Wake of the Global Financial Crisis’ (2010) 55 *McGill Law Journal*, 261.

⁶⁵⁴ Julia Black and David Rouch, ‘The Development of the Global Markets as Rule-makers: Engagement and Legitimacy’ (2008) 2 *Law and Financial Markets Review* 3, 223-225; see also Joanna Benjamin, Paul Bowden and David Rouch, ‘Law and Regulation for Global Financial Markets: Markets as Rule-makers – Enforcement, Dispute Resolution and Risk’ (2008) 2 *Law and Financial Markets Review*, 322-323; Joanna Benjamin and David Rouch, ‘The International Financial Markets as a Source of Global Law: The Privatisation of Rule-making?’ (2008) 2 *Law and Financial Markets Review* 2, 82-83.

⁶⁵⁵ Niamh Moloney, *How to protect investors. Lessons from the EC and the UK* (Cambridge: CUP 2010) 104. In particular, Moloney pointed to the fragility of the self-regulation in the retail markets observing that ‘investors are poorly equipped to monitor market actors and to price protections’.

⁶⁵⁶ Peter Yeoh (note 484) 208.

⁶⁵⁷ Manfred Gärtner, Björn Griesbach and Florian Jung, ‘PIGS or Lambs? The European Sovereign Debt Crisis and the Role of Rating Agencies’ (2011) 17 *International Advances in Economic Research*, 289.

The FSA made it clear that any attempts by regulators to supervise CRAs' methodologies would pose a number of complex challenges and that it did not see a case for pursuing such a form of intervention.⁶⁵⁸

In addition, the FSA considered that there was no evidence to suggest that regulators would be more accurate in assessing the appropriateness of methodologies than the CRAs. While the Turner Review can be considered a first concrete attempt to provide measures as to how to regulate CRAs, even further, its impact on the ratings system was ultimately modest and above all needed to be implemented by more intrusive regulatory measures.

After providing a critical appraisal of the FSA's Turner Review, the next section considers the EU initiatives adopted for increasing CRAs' accountability.

3.3.2 The European legal system with regard to CRAs: overview of the regulatory landscape

The European legal platform for CRAs had been justified mainly on the ground of the market regulating effects of the reputation of CRAs.⁶⁵⁹ In particular, the normative framework is constituted by the CRD⁶⁶⁰, the Market Abuse Directive (MAD)⁶⁶¹ and the Markets in Financial Instruments Directive (MiFID).⁶⁶²

The first, significant initiative was the European Commission's Communication on CRAs of 2006.⁶⁶³ The Communication followed the European Parliament's Resolution adopted in February 2004 on the role and methods of

⁶⁵⁸ FSA, 'A Regulatory Response to the Global Banking Crisis', Discussion Paper, March 2009, 171.

⁶⁵⁹ Mads Andenas, 'Credit Rating Agencies, Their Regulation and Civil Liability in the European Union' (2012) 1 *Law and Economics Yearly Review*, 268.

⁶⁶⁰ Directive 2006/48/EC (note 513).

⁶⁶¹ Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) (OJ 2003 L 96, p. 16). The Market Abuse Directive applies to CRAs as far as there is market manipulation within the meaning of Article 1 of the text, which is in the event that CRAs know or should know that their ratings are inaccurate. The Directive has been replaced by Directive 2014/57/EU on criminal sanctions for market abuse (OJ 2014 L 173, p. 179).

⁶⁶² Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ 2004 L 145, p. 1). The Directive has been replaced by Directive 2014/65/EU on markets in financial instruments (OJ 2014 L 173, p. 349).

⁶⁶³ Communication from the Commission on Credit Rating Agencies (OJ 2006 C 59, p. 1).

CRAs.⁶⁶⁴ It concluded that the MAD and the CRD, combined with the IOSCO Code, could provide a satisfactory answer to the major issues of concern in relation to CRAs.⁶⁶⁵

The EU initiative recognized the vital role played by CRAs in global securities and the banking sector and underlined the need to regulate ratings activity with some robust legislation. However, the European Securities Markets Expert Group (ESME) and the former Committee of European Securities Regulators (today ESMA) affirmed that closer supervision of CRAs would not be a valid option because of the high costs to be implemented in the securities regulation.⁶⁶⁶

In the aftermath of the 2007-2009 financial crisis and following the collapse of Lehman Brothers, the EU institutions changed the regulatory landscape by proposing to establish a comprehensive legal framework for CRAs. In particular, the Commission argued that EU legislation appeared to be the only option left that could sufficiently protect investors and the European financial markets against the risk of malpractice by CRAs.⁶⁶⁷

The Commission was aware of the deficiencies of the self-regulation system which existed in Europe and other jurisdictions and moved towards a strong regulatory regime for CRAs by proposing rules that were more robust and more enforceable.

On 12 November 2008, the Commission formally published its proposal to regulate CRAs.⁶⁶⁸ The proposal was accompanied by an impact assessment that analysed the following policy strategies: (1) self-regulation that could be based on the IOSCO Code, on an industry ‘white paper’ or on initiatives by individual CRAs; (2) a voluntary European code of conduct for CRAs developed by the industry and based on the ‘comply or explain’ approach. This came with a monitoring body that would check compliance of that code; (3) a Commission

⁶⁶⁴ European Parliament, ‘Resolution on Role and Methods of Rating Agencies’ (2003/2081(INI)), January 2004. This resolution recognized the positive and active role of CRAs in the financial markets but also highlighted certain questions that warranted further action to ensure the CRAs performed their role in a responsible way. The Resolution called for an analysis of the convenience of setting a registration regime for CRAs in the EU.

⁶⁶⁵ Raquel García Alcubilla and Javier Ruiz del Pozo (note 458) 48.

⁶⁶⁶ European Securities Markets Expert Group (note 452); see also Committee of European Securities Regulators, ‘CESR’s Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO code and the role of credit rating agencies in structured finance’, CESR/08-277, May 2008.

⁶⁶⁷ European Commission, ‘Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies’, COM (2008) 704 final, November 2008, 4-5.

⁶⁶⁸ *ibid.*

Recommendation setting standards that CRAs would have to comply with to operate in the EU but without an enforcement mechanism; and (4) EU legislation introducing a registration procedure and substantive requirements.

The legislation was adopted in September 2009 (CRA Regulation No 1060/2009).⁶⁶⁹ It set out a legally binding pan-European authorization regime for CRAs by targeting the problem of conflicts of interest and ratings quality. Some academics acknowledged that ‘the CRA Regulation introduces for the first time Community legislation on CRAs and this has meant incorporating a series of terms into Community law which until now were only used by the market’.⁶⁷⁰ Other academics, however, argued that although the CRA Regulation introduced the essential checks on CRAs’ behaviour and that it seemed to be a well-balanced instrument, it did not adequately address the issues of rating competence, methodology, proprietary disclosure and accountability.⁶⁷¹ Subsequently, it was proposed to amend the Regulation in order to appoint ESMA as the supervisory body for rating agencies. ESMA was designated to take over registration and approval, standard-setting, ongoing supervision and enforcement.⁶⁷²

Regulation No 513/2011 (‘2011 CRA Regulation’)⁶⁷³ amended Regulation No 1060/2009 by establishing specific rules to reinforce the public enforcement model, and introduce rules on a registration requirement, conflicts of interest, transparency requirements and the quality of the rating methodology, and civil liability of CRAs vis-à-vis their clients.

Regulation No 1060/2009 (‘2009 CRA Regulation’) marked the first official regulatory measure of CRAs at EU level and was the first act explicitly to acknowledge the potential regulatory use of ratings by EU-based financial institutions. Under the 2009 CRA Regulation, competent national authorities were responsible for supervising CRAs, backed up by an operational network of national supervisory authorities.⁶⁷⁴

⁶⁶⁹ Regulation (EC) No 1060/2009.

⁶⁷⁰ Raquel García Alcubilla and Javier Ruiz del Pozo (note 458) 58.

⁶⁷¹ Panagiotis K. Staikouras, ‘A Theoretical and Empirical Review of the EU Regulation on Credit Rating Agencies: In Search of Truth, Not Scapegoats’ (2012) 21 *Financial Markets, Institutions & Instruments* 2, 83-85.

⁶⁷² European Commission, ‘Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EC) No 1060/2009 on credit rating agencies’, COM(2010) 289 final.

⁶⁷³ Regulation (EC) No 513/2011.

⁶⁷⁴ Niamh Moloney, ‘EU Financial Regulation after the Global Financial Crisis: “More Europe” or More Risks?’ (2010) 47 *Common Market Law Review* 5, 1359. The author noted that ‘the 2009

Regulation No 513/2011 gave ESMA powers to manage supervision and registration procedures with the aim of ensuring a high level of consumer and investor protection. It no doubt improved cooperation between the centralized ESMA and national competent authorities and provided that a CRA established in the EU must be registered in order to conduct rating activities and distribute ratings to the public in the European Union.⁶⁷⁵

Regulation No 1060/2009 has been amended by Regulation No 462/2013⁶⁷⁶—a legislative act accompanied by Directive No 14/2013⁶⁷⁷—that imposes significant obligations on credit rating agencies. Although these measures attempt to establish a comprehensive normative framework for CRAs, it has been observed that ‘EU countries did not regulate CRAs through any coordinated regional or national efforts’.⁶⁷⁸

The 2009 Regulation conceded that CRAs have failed. Firstly, there was the failure not to reflect the worsening market conditions early enough in their credit ratings, and secondly, the failure to adjust their credit ratings in time following the deepening market crisis.⁶⁷⁹

The introduction of a new supervisory regime for CRAs constituted an important step for reforming the activity of rating agencies. However, the fundamental question is whether the EU legislation is capable of minimizing the negative consequences of ratings failures.⁶⁸⁰

Regulation imposes a comprehensive set of binding rules, which, by contrast with the US regime, address substantive operational and organizational rules in some detail, as well as disclosure-related rules’.

⁶⁷⁵ Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford: Oxford University Press 2014) 638. The author observes that although ‘for the first time in EU securities and markets regulation, supervision and enforcement powers were centralized within ESMA (...) in terms of achieving outcomes, these measures might be regarded as the equivalent of ‘picking low-hanging fruit’. See also Iain MacNeil, *An Introduction to the Law on Financial Investment* (2nd edn, Oxford and Portland, Oregon: Hart Publishing 2012) 438.

⁶⁷⁶ Regulation (EU) No 462/2013.

⁶⁷⁷ Directive 2013/14/EU of the European Parliament and of the Council of 21 May 2013 amending Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers in respect of over-reliance on credit ratings (OJ 2013 L 145 p. 1).

⁶⁷⁸ Chris Brummer and Rachel Loko (note 487) 15.

⁶⁷⁹ Recital 10 in the preamble to Regulation (EC) No 1060/2009.

⁶⁸⁰ Nina Dietz Legind and Camilla Hørby Jensen, ‘The European Regulation of Credit Rating Agencies’ (2014) 30 *Law in Context* 1, 114. The authors observe that ‘while credit rating agencies were prominent as one of the immediate causes of the crisis, clearly regulation of credit rating agencies by itself would not have prevented the crisis, nor can such regulation prevent a future financial crisis’.

After providing an overview of the EU regulatory scheme for CRAs, the next section examines Regulation Nos 1060/2009 and 513/2011 in greater detail, having regard to the major concerns of these normative measures.

3.3.3 Regulation (EC) No 1060/2009 and Regulation (EU) No 513/2011

The adoption of Regulation No 1060/2009 represented the transition of the rules governing CRAs from a self-regulatory to a government-regulated framework. The Regulation was a response to the spreading of the 2008 financial crisis and to the ongoing turmoil in the securities market. Previously, CRAs opted for a soft law regime by adopting the IOSCO Code, which is designed on a voluntary basis and without legally binding mechanisms.

One of the most important goals of the 2009 CRA Regulation has been an official recognition of the significant impact of CRAs on the operations of the markets and on the trust and confidence of investors and consumers.⁶⁸¹ The EU legislation considered ratings as an important reference for investment and financing decisions, credit activities and financial instruments.

However, the CRAs' performances have displayed manifest shortcomings during the recent financial crisis, particularly as a result of inflated ratings issued for certain products.⁶⁸² The 2010-2012 sovereign debt crisis has confirmed that the CRAs' assessments have negatively affected the liquidity problems of troubled EU Member States and influenced the financial assistance to solve the crisis.⁶⁸³

In simple terms, the 2009 CRA Regulation addresses the following aspects of the CRAs' market: (1) limited competition; (2) conflicts of interest; (3) organizational and record-keeping requirements; (4) rating disclosure; (5) rating

⁶⁸¹ Recital 1 in the preamble to Regulation (EC) No 1060/2009.

⁶⁸² Lynnette D. Purda, 'Assessing Credit or Determining Quantity? The Evolving Role of Rating Agencies' (2011) 21 *Journal of Applied Finance* 2, 20-21.

⁶⁸³ Norbert Gaillard, 'How and why credit rating agencies missed the Eurozone debt crisis' (2014) 9 *Capital Markets Law Journal* 2, 136, where it is argued that 'when CRAs began to downgrade peripheral Eurozone countries, the agencies were vehemently blamed for exacerbating the crisis. Such attacks were not entirely fair, given that credit ratings turned out to be more lenient than market-based indicators'. See also John Ryan, 'The negative impact of Credit Rating Agencies and proposals for better regulation' (January 2012) Stiftung Wissenschaft und Politik (SWP) Working Paper No 1, Research Division EU Integration, German Institute for International and Security Affairs, Berlin, 5; Remi Van de Calseijde, 'Quis custodiet ipsos custodies? The regulation of sovereign ratings by Regulation 462/2013' (2014) 20 *International Trade Law and Regulation* 1, 14.

accountability; and (6) transparency and market discipline. The measure introduced specific rules with regard to the management and supervision of registered CRAs. As is stated in the preamble, the Regulation aims to protect the stability of financial markets and investors.⁶⁸⁴

According to Article 1 of the 2009 CRA Regulation, the law introduces a common regulatory approach in order to enhance the integrity, transparency, responsibility, good governance and reliability of credit rating activities. The Regulation addresses the issuance of ratings only when they are used for regulatory purposes by EU-based financial institutions and does not create a general obligation for financial instruments to be rated under the 2009 CRA Regulation. Regarding the registration and supervision of CRAs, the legislation provides that credit institutions may use only ratings which have been issued by recognised ECAIs to determine the risk weights and the resulting capital requirements applied to a bank or investment firm's exposure.⁶⁸⁵

Regarding the rules of conduct for registered CRAs, the 2009 Regulation introduces stringent requirements for the issuance of credit ratings for structured finance. It also provides that CRAs must distinguish, by way of a particular symbol, rating categories attributed to structured instruments from rating categories used for other entities, financial instruments or financial obligations.⁶⁸⁶

The instrument requires CRAs to disclose, on an ongoing basis, information about all structured finance products submitted to them for their initial review or for preliminary rating, irrespective of whether their issuers contract them for a final rating.⁶⁸⁷

Registered CRAs are also required to disclose to the public the methodologies, models and criteria employed in their credit rating activities.⁶⁸⁸ CRAs are obliged to review their ratings continually in order to improve past performance and the quality of assessment. However, the 2009 CRA Regulation does not specify to

⁶⁸⁴ Recital 7 in the preamble to Regulation (EC) No 1060/2009.

⁶⁸⁵ Recital 44 in the preamble to Regulation (EC) No 1060/2009.

⁶⁸⁶ This approach reflects to a large extent the recommendations of the IOSCO Code, where it is stated that a CRA should differentiate ratings of structured finance products from traditional corporate bond ratings, through a different rating symbology.

⁶⁸⁷ Annex I-section D (II.4) to Regulation (EC) No 1060/2009. According to recital 41 in the preamble to Regulation (EC) No 1060/2009, CRAs should avoid situations in which issuers request a preliminary rating assessment from a number of CRAs in order to identify the one offering the best credit rating for the proposed structured finance instrument, and issuers should avoid engaging in such practices.

⁶⁸⁸ Article 11 of Regulation (EC) No 1060/2009.

what extent CRAs have to reveal their methodologies.⁶⁸⁹ In this context, it has been pointed out that ‘while full disclosure of methodologies can contribute to a better understanding of the value of credit ratings, full disclosure could create strong disincentives to use the best available methodologies and to invest in better rating methodologies’.⁶⁹⁰

Regarding the equivalence and endorsement regime, the 2009 CRA Regulation establishes a mechanism for recognizing ratings assigned by CRAs outside the Eurozone. Registered CRAs can endorse the ratings given by their affiliates outside the Eurozone on the basis of certain requirements.⁶⁹¹ These provisions aim to ensure the efficient and effective supervision of the activities of CRAs located outside the EU.

Articles 14 to 20 of the 2009 CRA Regulation impose the conditions and procedure for the granting or withdrawal of registration. The procedure is characterized by a complex system of authorization and agreements between the former CESR and the competent national authorities of the Member State.

The authorization regime is based on three different types of registration: (1) registration system for CRAs established in the EU; (2) endorsement scheme for ratings issued in third countries; and (3) a certification procedure for ratings issued in third countries and related to entities or financial instruments issued in third countries.

This regime was criticized for its ineffectivity in dealing with disagreements between national authorities and for its failure to make clear the division of responsibilities between the competent authority of the Member State and the other competent authorities.⁶⁹²

The 2011 CRA Regulation sought to remedy these shortcomings. However, the dividing lines between national supervision authorities have still not been

⁶⁸⁹ Recital 25 in the preamble to Regulation (EC) No 1060/2009: ‘credit rating agencies should disclose information to the public on the methodologies, models and key rating assumptions which they use in their credit rating activities. The level of detail concerning the disclosure of information concerning models should be such as to give adequate information to the users of credit ratings in order to perform their own due diligence when assessing whether to rely or not on those credit ratings’.

⁶⁹⁰ Jacob de Haan and Fabian Amtenbrink, ‘Credit Rating Agencies’, De Nederlandsche Bank Working Paper No 278, January 2011, 23.

⁶⁹¹ Articles 4 and 5 of Regulation (EC) No 1060/2009.

⁶⁹² Jacob de Haan and Fabian Amtenbrink (note 690) 21-22.

adequately addressed, which leads to negative consequences in terms of transparency and market stability.

Academic commentators have observed how the 2009 Regulation has taken the approach of fostering competition by way of authorization and registration mechanisms, and rating disclosure through transparent credit assessment and by eliminating rating shopping.⁶⁹³ In essence, the main objectives of the 2009 Regulation are: (1) addressing conflicts of interest; and, (2) ensuring market competition. Under the conflicts-of-interest heading, Article 6 of the 2009 CRA Regulation aims to ensure the independence of ratings by obliging CRAs to implement adequate internal controls so as to avoid collusive behaviour within the issuer-pays business model. This provision seeks to mitigate against dubious relationships between analysts, employees and other persons involved in the rating activities.⁶⁹⁴ Under the market competition head, the 2009 CRA Regulation does not enshrine specific rules for governing the high access barriers in the CRAs market.

The registration system and the information disclosure regime do not seem sufficient in themselves to increase competition among S&P's, Moody's and Fitch. New rating firms could not easily fill the reputational gap of the most widely recognized CRAs because of their 'consolidated names'. EU legislation should consider the option of introducing comparative measures to assess the accuracy of CRA estimates in order to ensure equal treatment for all rating agencies.

It may be said that the 2009 CRA Regulation provides a catalogue of rules of conduct—inspired mainly by the 2008 IOSCO Code of Conduct—with which rating agencies must comply in order to foster market transparency and investor confidence. Nonetheless in 2010, the European Commission proposed amendments to Regulation No 1060/2009 in order to: (1) strengthen information disclosure for the rating of structured finance instruments; (2) establish a central

⁶⁹³ Panagiotis K. Staikouras (note 671) 89.

⁶⁹⁴ Article 6 of Regulation (EC) No 1060/2009, which states that “a credit rating agency shall take all necessary steps to ensure that the issuing of a credit rating is not affected by any existing or potential conflict of interest or business relationship involving the credit rating agency issuing the credit rating, its managers, rating analysts, employees, any other natural person whose services are placed at the disposal or under the control of the credit rating agency, or any person directly or indirectly linked to it by control”.

single regulatory body; and (3) reduce over-reliance on CRAs.⁶⁹⁵ As a result of the new rules, issuers were required to provide the appointed CRA with access to a password-protected website to retrieve all information necessary for the CRA initially to determine or monitor the credit rating of a structured finance product.⁶⁹⁶

One of the main shortcomings of the 2009 CRA Regulation concerns the supervision regime. Member States have to identify competent national authorities with the task of ensuring that CRAs comply with the Regulation. EU national legislators must equip competent authorities with a set of supervisory measures at their disposal to prohibit or suspend the use of credit ratings when a CRA breaches the obligations set out in the Regulation.⁶⁹⁷

The authorities are obliged to lay down the rules on penalties, which may be criminal or administrative. Competent authorities must also impart all rules that are applicable to infringements of the provisions of the Regulation and should take all measures necessary to ensure that they are implemented. The penalties that authorities can issue should be effective, proportionate and dissuasive. They should also, at least, cover cases of gross professional misconduct and lack of due diligence.⁶⁹⁸

However, such a regulatory system leaves room for discretion and unmonitored actions. The 2009 CRA Regulation does not provide either the legal resources to enforce the absence of cooperation between national authorities or legally binding mechanisms to enforce the inactivity of authorities. In this regard, the main criticism of 2009 CRA Regulation was that it did not empower a European body to oversee the CRA operations. In harsher terms, the 2009 CRA Regulation did not provide a single supervisory authority for rating agencies.

After the adoption of Regulation No 513/2011, the supervision of CRAs became more centralized.⁶⁹⁹ The new legislation designated ESMA with

⁶⁹⁵ The amendments were approved and finally signed into law in June 2011. The new rules came into force in July 2011.

⁶⁹⁶ A third-party CRA can request access to this website provided that it meets certain requirements.

⁶⁹⁷ Article 24 of Regulation (EC) No 1060/2009.

⁶⁹⁸ Article 36 of Regulation (EC) No 1060/2009.

⁶⁹⁹ Niamh Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (2) Rules in Action' (note 184) 205, where it is pointed out that 'the transfer of direct supervisory power over rating agencies is a major development as it has required the EU legislative institutions to design an operational model which may support extensive transfers of direct power in the future'.

competence in matters relating to the ongoing supervision of registered CRAs.⁷⁰⁰ ESMA is responsible for the registration and ongoing supervision of credit rating agencies, but not for oversight of the users of credit ratings. It has the competence to delegate specific supervisory tasks to national authorities, including powers to request information, to launch investigations, and to perform on-site inspections. ESMA is also responsible for the endorsement of the ‘as stringent as’ test for ratings produced by credit rating agencies outside the EU.⁷⁰¹ However, the fact that ESMA is not an independent institution when it comes to monitoring rating performance may generate some doubts as to any objective improvements in the transparency of CRAs.

Regulation No 1060/2009 and the 2011 CRA Regulation failed to make the division of responsibility among the authorities clear.⁷⁰² The evidence now emerging as to ESMA’s supervisory powers and activities on CRAs⁷⁰³ suggests that the regulatory framework has been effective after the implementation of 2013 CRA Regulation.

In this context, ESMA adopted a risk-based approach to supervising CRAs in order to improve compliance with the provisions of the 2013 CRA Regulation. ESMA’s activities include formal requests for information, the conduct of inspections and investigations as well as the enforcement actions in appropriate cases (e.g. remedial action plan and the appointment of an Independent Investigating Officer).⁷⁰⁴ However, supervision of CRAs’ internal governance—

⁷⁰⁰ According to recital 6 in the preamble to Regulation (EU) No 513/2011, ‘ESMA should be exclusively responsible for the registration and supervision of credit rating agencies in the Union’.

⁷⁰¹ CESR, ‘Call for Evidence: Fact Finding Exercise of the Use in the European Union of Ratings Issued by Third Country CRAs’, CESR/09-681, 3 July 2009.

⁷⁰² Niamh Moloney, ‘Reform or revolution? The financial crisis, EU financial markets law, and the European Securities and Markets Authority’ (2011) 60 *International and Comparative Law Quarterly* 2, 528. The author pointed out that the *Meroni* doctrine (Case 9/56, *Meroni v. High Authority* [1957–1958] ECR 133) posed delicate constitutional and institutional balance questions with respect to direct supervision of credit rating agencies. In particular, the *Meroni* ruling provides that discretionary powers involving a wide margin of discretion cannot be delegated by an EU institution. As a result, ‘the *Meroni* constraint has led to a complex regime which governs ESMA’s exercise of enforcement powers...the constitutional and procedural complexities attendant on ESMA’s structure and powers are considerable and suggest some institutional anxiety as to *Meroni* compliance’.

⁷⁰³ European Securities and Markets Authority, ‘ESMA fines DBRS Ratings Ltd. for internal control failings’, ESMA/2015/1050, 29 June 2015.

⁷⁰⁴ European Securities and Markets Authority, ‘ESMA supervision of Credit Rating Agencies and Trade Repositories’, Annual Report and Work Plan, 16 February 2015, 6-7. According to Article 23e of the CRA Regulation, ESMA will appoint an Independent Investigating Officer to investigate, where it finds that there are ‘serious indications of the possible existence of facts liable to constitute’ an infringement, whether it relates to conflict of interest, organizational or

clarity regarding staff roles and responsibilities, and the involvement of ratings analysts in business development—seems a difficult task for regulators.⁷⁰⁵

As ESMA has claimed, ‘compliance with a number of these points could not be demonstrated, typically because policies and procedures did not describe in sufficient detail the different steps of the process followed or did not clearly allocate roles and responsibilities’.⁷⁰⁶ Closer examination of ESMA’s supervisory duties leaves the impression that rating methodologies are not supervised effectively. The task force launched by Community regulations aimed at reinforcing ESMA’s power of supervision may clash with the CRAs’ internal review and compliance procedures. The upshot is that CRAs can continue their activity largely unmonitored within the areas of conflicts of interest and market concentration.

Unlike in the US, the European Commission reacted to the global crisis by supervising CRAs more closely, rather than by excluding references to their ratings in regulations. The EU legislative bodies are aware that new registration requirements may lead to a false sense of security as the US is at pains to state that ratings should be monitored thoroughly. However, ‘the fact that ratings are embedded in official EU regulation may be interpreted as implying a seal of approval and would thus further encourage excessive reliance on ratings by investors who should be conducting their own due diligence’.⁷⁰⁷

After providing an analysis of the EU regulatory scheme for CRAs, the next section critically discusses the main features of Regulation No 462/2013 adopted to reform ratings governance.

operational requirements, to obstacles to the supervisory activities and to disclosure provisions.

⁷⁰⁵ Gudula Deipenbrock, ‘After ‘CRA III – Achievements and Challenges from the Legal Perspective’, paper presented at the ‘Proceedings of the Workshop on Credit Rating Agencies - Implementation of Legislation’, European Parliament, Directorate General for Internal Policies, Brussels, 18 March 2014. It is claimed that ‘considerable progress has been made with a view to rating-directed regulation. However, the CRA III Regulation might not be considered to have played so far or play an important part in tackling the dysfunctions of the European credit rating sector’ (at 11).

⁷⁰⁶ European Securities and Markets Authority (note 704) 14.

⁷⁰⁷ Fabian Amtenbrink and Jacob de Haan, ‘Regulating Credit Ratings in the European Union: A Critical First Assessment of Regulation 1060/2009 on Credit Rating Agencies’ (2009) 46 *Common Market Law Review* 6, 1948.

3.3.4 Regulation No 462/2013 as a European response to the perceived shortcomings of CRAs

It appears that EU legislation has not alleviated the major concerns about the rating business, which are principally limited competition, conflicts of interest and over-reliance. The EU's regulatory policies have not managed to improve competition in the ratings industry or to avoid the opacity of the standards and methodologies used to produce the ratings.

Although one of the driving forces behind the adoption of the EU authorization regime for CRAs has been the fostering of competition, closer examination of the 2009 CRA Regulation reveals that the word 'competition' is missing from the text and there is no explicit reference to the need to foster competitive forces in the ratings market.⁷⁰⁸

It is instructive to note that a lack of competition in the ratings industry deprives the market from an effective control mechanism over product quality and pricing, while also removing incentives to innovate. On this point, it has been noted that 'on the structure of the industry, the EU increases the barriers to entry, by introducing a license and setting tight regulation, rather than taking the oligopolistic nature as one of the fundamental reasons for the abuses'.⁷⁰⁹

The 2009 CRA Regulation did not provide for a separate regulatory regime for CRAs and did not establish a system to enforce ratings activity. Instead, the legislation concentrated all the regulatory activity into the competent national authorities.⁷¹⁰ In addition, the 2009 CRA Regulation did not provide specific rules about the regulation of the CRAs' ownership composition.

As indicated in Chapter one, the internal governance of the main rating agencies is generally considered a "grey area". Internal governance activities of risk management raise a number of doubts about the actual independence of their conduct. The transparency of CRAs represents a pressing challenge for regulators and policymakers who find it difficult to determine a normative regime that will

⁷⁰⁸ Panagiotis K. Staikouras (note 671) 83.

⁷⁰⁹ Karel Lannoo, 'What reforms for the credit rating industry? A European perspective' European Capital Markets Institute Policy Brief No 17, October 2010, 5.

⁷¹⁰ Harry McVea, 'Credit Rating Agencies, the Subprime Mortgage Debacle and Global Governance: the EU Strikes Back' (2010) 59 *International and Comparative Law Quarterly* 3, 713-714.

encourage rating behaviour so as to provide all relevant information to the market.⁷¹¹

The previous non-binding regulatory regime for CRAs favoured opaque ratings and ineffective due diligence with respect to ratings methodologies. Furthermore, ‘the acceptance of external credit assessment for the determining of capital requirements has effectively resulted in the ‘outsourcing of regulatory judgement’, whereby it is not the CRA that bears the final risk, but rather the taxpayer that may have to come to the rescue of a failing systemically relevant institution’.⁷¹²

Proposals to enhance more competition and diversity in rating agencies have been considered at EU level. The European Parliament presented a resolution that proposed the establishment of a new independent European Credit Rating Foundation⁷¹³ with the possibility of launching ‘a network of smaller European rating agencies, in an effort to bring more competition into the industry’.⁷¹⁴

In this way, the creation of a new Europe-based rating agency that specialises in sovereign debt could represent a solution to the shortcomings.⁷¹⁵ However, the prospect of a European rating agency remains a vague one, since the EU institutions have not yet reached a decision as to how such an entity would be founded or where it might be based. In addition, the proposed government-sponsored rating agency would be likely to find it difficult to establish its credibility in a market dominated by S&P’s, Moody’s and Fitch.⁷¹⁶

The hypothesis that an external independent authority for rating agencies could be a viable option to build confidence in ratings of creditworthiness needs to be verified in practice. Ratings should be regulated under a single regulatory framework constituted by an internationally established code. This should be seen in conjunction with the idea of having a single independent authority.

⁷¹¹ Paul J. Justensen, ‘Ratings Recall: Will New Reform Proposals Make Lasting Impact?’ (2009) 35 *The Journal of Corporation Law* 1, 205-206.

⁷¹² Jacob de Haan and Fabian Amtenbrink (note 690) 33.

⁷¹³ European Parliament, Resolution of 8 June 2011 on credit rating agencies: future perspectives (2010/2302(INI)).

⁷¹⁴ Nikki Tait, ‘Calls mount for EU action on rating agencies’ *Financial Times* (London, 8 June 2011).

⁷¹⁵ Sylvester C.W. Eijffinger, ‘Rating Agencies: Role and Influence on Their Sovereign Credit Risk Assessment in the Eurozone’ (2012) 50 *Journal of Common Market Studies* 6, 919-920.

⁷¹⁶ James Weston, ‘An Improved Regulatory Framework for Credit Rating Agencies’ (2012) *Global Credit Review* 2, 26.

Another challenge for regulators is how to increase the level of investor protection by reducing the moral hazard effects of inflated ratings.⁷¹⁷ In this context, the EU enacted Regulation No 462/2013 ('2013 CRA Regulation') which is aimed at re-regulating the CRAs and in which it sought to address the major concerns such as the conflicts of interest in the market for credit ratings, rating agency behaviour and the agencies' liability. Specifically, the 2013 CRA Regulation requires issuers to rotate regularly the agencies that rate government bonds and financial products. The rationale underpinning this policy is to open up competition and avoid conflicts of interest. According to these rules, CRAs may rate State debts under specific restrictions: unsolicited sovereign ratings may be published at least twice but no more than three times a year, on dates published by the rating agency at the end of the previous year. Also, these ratings may be published only after markets in the EU have closed and at least one hour before they reopen.

As regards conflicts of interest, a CRA will have to refrain from issuing ratings, or disclose that its ratings may be affected, if a shareholder or member holding ten percent of the voting rights in that agency has invested in the rated entity. Then, it is provided that no one may simultaneously hold stakes of more than five percent in more than one CRA, unless the agencies concerned belong to the same group.⁷¹⁸

As far as the potential liability of CRAs is concerned, investors who rely on a credit rating could sue the agency that issued it for damages if it breaches the rules set out in this legislation either intentionally or by gross negligence, regardless whether there is any contractual relationship between the parties.⁷¹⁹ As discussed in Chapter five, Article 35a of Regulation No 462/2013⁷²⁰ establishes the civil liability regime for CRAs by introducing specific provisions to the claimant's standing. Detailed procedural aspects are required for investors who have reasonably relied on an incorrect rating, as well as the issuers who provided information that led to the inaccurate rating.

⁷¹⁷ Mads Andenas (note 659) 273.

⁷¹⁸ Recital 23 in the preamble to Regulation (EU) No 462/2013 amending Regulation (EC) No 1060/2009 on credit rating agencies.

⁷¹⁹ *ibid* recitals 32-33.

⁷²⁰ Article 35a(1) of Regulation (EU) No 462/2013.

In this respect, two questions arise. The first is to what extent the 2013 CRA Regulation has provided for a level of enforcement such as to impose liability for misleading statements and misconduct during the ratings process, combined with the quantum of compensation to the investor for losses suffered. The second question concerns the minimum degree of financial knowledge that will exonerate CRAs from liability where evaluations have been supplied to the market.

As third parties do not have close insight of the internal procedures of CRAs, a partial reversal of the burden of proof—with regard to the existence of an infringement—and the infringement’s impact on the rating outcome seems to be appropriate. However, the burden of proof as regards the existence of damage and the causality of the infringement for the damage, both being closer to the sphere of the third party, should be fully attached to the third party.

Finally, with respect to the publication of ratings on the European rating platform, the new rules allow all available ratings to be published on this platform. This allowance will improve the comparability and visibility of all ratings for any financial instrument rated by rating agencies registered and authorized in the EU.⁷²¹

It is evident that the EU legislator has introduced a rules-based regime in which CRAs are subject to closer supervision and pervasive internal controls. The new regulatory approach aims to ensure accountability to investors through clarity of responsibility between the competent authorities. The 2013 CRA Regulation is designed to govern the conduct of CRAs and the market structure risks. In this light, the 2013 CRA Regulation represents a possible way of bringing back confidence within ratings’ activities. As Andenas has pointed out, ‘the regulatory regime in the EU seems to be pulling out all the stops to deal with rating accuracy in response to the recognized market failures in the credit rating industry’.⁷²²

Above all, the accuracy of and the methods employed by CRAs will be a chief factor in enhancing market confidence. This is because it is only if there is clear accountability between participants that it will be possible to rebuild a fiduciary relationship in the financial markets. In other words, the credibility of CRAs can be measured in terms of intermediaries’ accountability, not only from the point of view of the suitability of market actors, but also of effective enforcement. One can

⁷²¹ EU Focus, ‘New rules for credit ratings agencies agreed’ (2013) 18-19.

⁷²² Mads Andenas (note 659) 312.

argue that the road to achieving accuracy about CRAs' *modus operandi* must presuppose a strong structure of self-regulation in terms of right behaviours and actions. However, the main task of the 2013 CRA Regulation is not only to address the weaknesses of the CRAs market but also to reduce the risks posed by ratings to financial stability. In addition, it seeks to reduce the procyclicality of ratings in the financial system.⁷²³

The next chapter focuses on the accountability of the CRAs, in particular on generic grounds of liability such as contract, tort, fiduciary duty, estoppel and statutory right of action. It is considered whether the doctrine of estoppel constitutes a viable solution to hold credit rating agencies responsible vis-à-vis investors.

⁷²³ Niamh Moloney (note 675) 651, where it is observed that 'the CRA III reforms, however, represent an attempt to address structural market weaknesses'.

Chapter Four

Mapping the Liability Contours for Credit Rating Agencies

4.1 Introduction

This chapter examines the accountability regime for CRAs, notably the extent to which CRAs may be held liable for issuing inaccurate ratings.

Before discussing in detail the major questions raised CRAs' liability, it is helpful to outline the notion of accountability. Accountability may be usefully defined as an obligation to give account of, explain and justify one's actions.⁷²⁴ In the sense of a clear definition of responsibility, accountability comprises four elements: (1) a holder of power; (2) an authority to whom accountability is owed; (3) the content of the obligation; and (4) criteria of assessment.⁷²⁵ This notion of accountability essentially reflects the theory of the division of powers and the existing system of checks and balances.⁷²⁶

Accountability of CRAs in the financial markets may be considered from the point of view of private law. Recently, the role of the courts in the private law aspects of financial law has been predominantly considered with reference to the crisis-era experience. In particular, private-law actions have been widely used to contain systemic risk in the case of financial failures, and to address the costs of damages in the case of compensation for losses. The relative merits of private disciplining techniques are essentially 'to provide quick solutions in complex and time-pressured circumstances' through contractual clauses or court decisions.⁷²⁷ For example, in *RAB Capital Plc v Lehman Brothers International (Europe)*, the

⁷²⁴ Rosa M. Lastra, *International Financial and Monetary Law* (Oxford: OUP 2015) Chapter 2.

⁷²⁵ Rosa M. Lastra and Fabian Amtenbrink, 'Securing Democratic Accountability of Financial Regulatory Agencies – A Theoretical framework' in Richard V. de Mulder (ed), *Mitigating Risk in the Context of Safety and Security. How Relevant is a Rational Approach?* (Rotterdam: Erasmus School of Law & Research School for Safety and Security (OMV 2008) 115-132; Luis Garicano and Rosa M. Lastra, 'Towards a new Architecture for Financial Stability: Seven Principles' (2010) 13 *Journal of International Economic Law* 3, 616. See also Julia Black, 'Constructing and contesting legitimacy and accountability in polycentric regulatory regimes' (2008) 2 *Regulation & Governance* 2, 149-152.

⁷²⁶ *ibid.*

⁷²⁷ Michael Bridge and Jo Braithwaite, 'Private Law and Financial Crises' (2013) 13(2) *Journal of Corporate Law Studies*, 365, where it is also observed that 'private law complements the relevant regulatory regime; while the role of the latter may be said to keep the plane in the air, private law minimizes the damage if it hits the ground'.

court considered whether a proprietary claim under a prime brokerage agreement against a company in administration could be expedited.⁷²⁸ Discussion of the role of private-law remedies has the benefit of analysing the difficulties posed by private litigation in different judicial systems and clarifying the legal reasoning by which liability might attach to a CRA. It would also have the benefit of explaining the link between the systemic impact of CRAs' activities on financial stability and the private-law framework applicable to CRAs.

In this context, the public interest in maintaining financial stability and the enforcement function of a private liability regime are directed to securing protection for retail investors. As MacNeil has observed, 'the emphasis on *ex ante* prevention of systemic risk means that *ex post* enforcement action cannot play a major role in prudential supervision because by that time the regulator will have failed to secure the regulatory objective'.⁷²⁹ The flexibility of private law may contribute to pressing regulatory objectives for CRAs such as transparency and market integrity, and may assist the regulatory authorities in identifying the risks of ratings.

The next section takes into account the liability scenario under the tort law regime by considering whether agencies may be regarded as being subject to a duty of care with respect to the market and investors. In particular, the analysis considers the degree of liability by taking into account the various positions taken by the courts.

4.2 *The liability regime for CRAs under tort law: a possible duty of care?*

CRAs should provide proper ratings of the debt liability and probability of default while owing their duty to market and investors. However, CRAs are largely immune from liability and seemingly do not owe any duty of care to market participants. As a result, it is difficult to demonstrate the reliance necessary to be successful in a fraud or negligence action against a CRA.⁷³⁰ As one commentator put it, 'since the agencies have no contractual relationship with,

⁷²⁸ See *RAB Capital Plc & Anor v Lehman Brothers International (Europe)* [2008] EWHC 2335 (Ch).

⁷²⁹ Iain MacNeil, 'Enforcement and Sanctioning' in Niamh Moloney, Eilis Ferran and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford: OUP 2015) 293.

⁷³⁰ Nan S. Ellis, Lisa M. Fairchild and Frank D'Souza, 'Is Imposing Liability on Credit Rating Agencies a Good Idea?: Credit Rating Agency Reform in the Aftermath of the Global Financial Crisis' (2012) 17 *Stanford Journal of Law, Business & Finance* 2, 183-184.

or fiduciary duty to, bond investors, they can publish any opinion without being liable'.⁷³¹

In order to understand a possible option for holding CRAs liable, due consideration should be given to the English tort of negligence⁷³² with particular attention to the duty of care and misrepresentation.⁷³³ As Chitty and Beale have observed, 'a negligent misrepresentation is one which is made carelessly, or without reasonable grounds for believing it to be true'.⁷³⁴ A misrepresentation generally involves only one of a number of causes operating on the mind of the representee which induced the change of position. For example, in the listing particulars, a prospectus may contain a mass of correct information calculated to induce a subscription, but a single misrepresentation could support a cause of action.⁷³⁵ In this context, prospectus liability is based on negligent misstatements and extends to directors and indeed all those who endorse the prospectus.⁷³⁶

However, depending on the jurisdiction, liability for misstatements in a prospectus can fall on any number of entities, including the issuing company and its directors and officers.⁷³⁷

⁷³¹ John Gapper, 'Rating agencies must beware of the law' *Financial Times* (London, 6 February 2013).

⁷³² Winfield and Jolowicz, *Winfield and Jolowicz on Tort*, W.V.H. Rogers (ed.) (18th eds., Sweet & Maxwell 2010) para 5.1, where negligence is defined as follows: "negligence as a tort is the breach of a legal duty to take care which results in damage to the claimant".

⁷³³ Misrepresentation can be defined as an ambiguous, false statement of fact or law which is addressed to the innocent party and which is possibly material and which induces him or her to enter into the contract. The representation would affect the judgement of a reasonable person. According to the Law Commission and the Scottish Law Commission, there are three main requirements for a misrepresentation: it must be (1) false; (2) factual; and (3) not an omission. In particular, a misrepresentation only counts if it relates to one of the matters specifically listed within it. See Law Commission Consultation Paper No 199 and Scottish Law Commission Discussion Paper No 149, 'Consumer Redress for Misleading and Aggressive Practices', Joint Consultation Paper, April 2011, 59.

⁷³⁴ *Derry v Peek* (1889) 14 App. Cas. 337 as cited in Joseph Chitty and Hugh G. Beale, *Chitty on Contracts*, General Principles, Volume 1 (31st eds., London: Sweet & Maxwell 2013) 613.

⁷³⁵ The Hon. K.R. Handley A.O., Q.C., 'Causation in misrepresentation' (2015) 131 *Law Quarterly Review*, 278.

⁷³⁶ On this discussion see Paul Davies, 'Liability for Misstatements to the Market: Some Reflections' (2009) 9(2) *Journal of Corporate Law Studies*, 297.

⁷³⁷ See *Kolassa v Barclays Bank* (C-375/13) where the Court of Justice of the European Union held that: (1) consumer investors can only bring prospectus liability claims in their home State if they have concluded a direct contractual relationship with the issuer, and only if the issuer has marketed the securities in their home State; (2) secondary market purchasers cannot invoke Article 5(1) of Regulation No 44/2001 (Brussels Regulation), which grants jurisdiction to the courts of the State where the relevant contractual obligation was to be performed; and (3) tortious or statutory claims can be brought in the jurisdiction where damage is suffered, which may be where investors' bank accounts are located. Issuers thus face the prospect of litigating parallel claims in multiple jurisdictions.

Types of misrepresentation include: (1) fraudulent misrepresentation; (2) negligent misrepresentation; and (3) innocent misrepresentation.⁷³⁸ The term ‘innocent misrepresentation’ means a representation which is neither fraudulent nor negligent, and no action for damages lies for a mere innocent misrepresentation.⁷³⁹

In *Nocton v Ashburton*, the House of Lords held that a duty of care may arise (even apart from contract) out of a fiduciary relationship and an action will lie in tort for negligent misrepresentation causing loss to the representee where the relationship of the parties is such as to give rise to a duty of care.⁷⁴⁰ This case underlined the question of economic losses flowing from a fiduciary relationship such as that of principal and agent.

In *Hedley Byrne v Heller Partners*, the court affirmed tort liability for negligent misstatement causing financial loss.⁷⁴¹ In particular, the ruling stated that even in absence of contract the success of a claim depends on proofs of a special relationship: the party making the representation—for instance, the CRA—has or purports to have some special skills or knowledge about the fact that the other party—for instance, the investor—would rely on the representation made.⁷⁴² This authority established the principle that giving negligent advice outside of a contractual relationship could give rise to liability for pure economic loss.

⁷³⁸ Misrepresentation can be defined ‘innocent’ when equity intervenes to protect those who might not otherwise have a remedy. Equity’s intervention is based on the idea that no one should be allowed to retain a benefit obtained by way of an untrue statement. Equity’s position is that misrepresentation is morally unacceptable even if innocent. The Misrepresentation Act 1967 created statutory liability for negligent misrepresentation which does not rely on a special relationship while innocent misrepresentation is now only relevant if made entirely without fault. See *Heilbut, Symonds & Co v Buckleton* [1913] A.C. 30; *Gilchester Properties Ltd v Gomm* [1948] 1 All E.R. 493; *Dick Bentley Productions Ltd v Harold Smith (Motors) Ltd* [1965] 1 W.L.R. 623. In doctrine see Mindy Chen-Wishart, *Contract Law* (4th edn, Oxford: OUP 2012) 222-223; Ewan McKendrick, *Contract Law: Text, Cases, and Materials* (5th edn, Oxford: OUP 2012) 580-581.

⁷³⁹ Joseph Chitty and Hugh G. Beale (note 734) 627.

⁷⁴⁰ *Nocton v Ashburton* [1914] A.C. 932. It should be noted that a fiduciary relationship arising out of a professional relationship supports a duty of care in tort for which ordinary tort damages are recoverable. See *Arenson v Casson Beckman Rutley & Co* [1977] A.C. 405 and *Midland Bank Trust Co Ltd v Hett Stubbs & Kemp* [1979] Ch. 384.

⁷⁴¹ *Hedley Byrne v Heller Partners Ltd* [1964] AC 465. The case concerned liability in tort to a person who suffered pecuniary loss through relying on a misleading statement, made carelessly but honestly. The Court of Appeal held that there may be a tortious claim for damages based upon a duty to take care, independent of contract or fiduciary obligations. For a commentary on this ruling see Douglas Payne, ‘Hedley Byrne & Co. Ltd. v. Heller & Partners, Ltd’ (1964) 6 *University of Western Australia Law Review* 4, 467.

⁷⁴² See Lord Reid and Lord Hodson in *Hedley Byrne v Heller Partners Ltd* [1964] A.C. 465 at 486 and 509, respectively.

If a CRA's *modus operandi* falls within the hypothesis of 'negligence', it is possible to argue that an implicit representation of existing fact, e.g. ratings, provided by CRAs can give rise to liability in tort for incorrect opinions and forecasts. This question could be analysed in the context of the business relationship between CRAs and issuers requesting the rating and therefore, with respect to investors in the case of damages for inaccurate or flawed evaluations.

On the base of the assumption that the credit rating agency did not take reasonable care in making the forecast, it could be held liable for losses caused by unreliable ratings produced in haste or when it is beyond its expertise to conduct proper ratings.⁷⁴³ Therefore, CRAs as 'guardians' of financial markets should owe a duty to perform their assessments with a certain degree of care and skill.⁷⁴⁴ If CRAs breach that duty, they commit the tort of negligence.⁷⁴⁵

However, liability in the tort of negligence is premised on fault which means it must be shown that the defendant was in breach of his duty to take reasonable care of the claimant.⁷⁴⁶ The existence of a duty of care is the primary requirement for a successful claim in negligence and it is very difficult to find CRAs owing

⁷⁴³ *Esso Petroleum Co v Mardon* [1976] Q.B. 801; *McNally v Welltrade International Ltd* [1978] I.R.L.R. 497; *Box v Midland Bank Ltd* [1979] 2 Lloyd's Rep. 391; *FoodCo UK LLP (t/a Muffin Break) v Henry Boot Developments Ltd* [2010] EWHC 358 (Ch). These cases show that the distinction between statements of existing facts and 'predictions' is not relevant for the purpose of establishing liability in tort. In doctrine see Mohammed B. Hemraj, 'Tort law and corrective justice: compensating investors' (2013) 34 *Company Lawyer* 11, 350. The author observes that 'investors cannot sue CRAs for breach of contract and any legal remedy they may claim lies in tort and specific statutory provisions' and notes that 'the regulators should compel CRAs to hold compulsory a professional indemnity insurance (PII) policy to compensate the investors for their losses arising from relying on inflated ratings being given by CRAs'.

⁷⁴⁴ To determine the objective standard of care or the level of care and skill required by the activity which the defendant was pursuing it should be noted that for every activity there is a certain minimum degree of care and skill that a defendant must exercise on pain of being found guilty of negligence. In *Glasgow Corporation v Muir* [1943] AC 448, the courts determined the standard of care in negligence as follow: 'the standard of foresight of the reasonable man is in one sense an impersonal test (...) Some persons are by nature unduly timorous and imagine every path beset with lions; others, of more robust temperament, fail to foresee or nonchalantly disregard even the most obvious dangers. The reasonable man is presumed to be free both from over-apprehension and from over confidence'. However, professionals are judged by the standard of a reasonable member of the profession.

⁷⁴⁵ Nicholas J. McBride and Roderick Bagshaw, *Tort Law* (4th eds., Pearson Education Limited 2013) 51-52. See also Mark Lunney and Ken Oliphant, *Tort Law: Text and Materials* (5th eds., Oxford: OUP 2013) 183-184. In substance, the measure of damages for a claim by an investor where there is no contract will be the damages that would be recoverable if the investor succeeded in a claim for negligence (i.e. a claim in tort) against the rating agency.

⁷⁴⁶ Mark Lunney and Ken Oliphant, *Tort Law: Text and Materials* (5th eds., Oxford: OUP 2013) 152.

any duty to the market or to investors because credit rating agencies are presumed to act as financial reporters.⁷⁴⁷

In this regard, the development of the case law has paid close consideration to the role of CRAs with respect to investors. In *Cassa di Risparmio della Repubblica di San Marino v Barclays Bank*, the judge affirmed that ‘a statement that an instrument was so rated (or was expected to be so rated) was, in turn, merely a statement about what the rating agencies’ *opinion* was (or about what it was expected to be)’.⁷⁴⁸

In asserting that the rating was a statement of the rating agencies’ expert opinion, the court did not find any advisory and fiduciary duties owed by CRAs to investors. This means that credit ratings are not regarded as vehicles that offer investment advice but instead merely provide the assessment of the creditworthiness of a given financial product. The significance of this case relies on the assumption that credit ratings do not provide a representation of fact about the default risk of a product since their evaluations, are by their very nature, a matter of estimation.

In *JP Morgan Chase Bank v Springwell Navigation Corp*, the English court made clear the distinction between the giving of advice (‘salesman’) and the relationship being such that, by giving advice, a party is accepting responsibility for that advice (‘investment adviser’).⁷⁴⁹ The court argued that it is inevitable during the sales process, for a salesman to provide comment, even opinion, on the

⁷⁴⁷ The English courts have made it clear that the existence of a duty of care is the primary requirement for a successful claim in negligence. If there is no duty, the failure to take reasonable care cannot give rise to liability. See *Donoghue v Stevenson* [1932] AC 562. This case established the liability for negligence as a specific tort in case of failure to exercise a duty of care which the circumstances demand. It has been pointed out that ‘the liability for negligence, whether you style it as such or treat it as in other systems as a species of ‘culpa’, is no doubt based upon a general public sentiment of moral wrongdoing for which the offender must pay. But acts or omissions which any moral code would censure cannot in a practical world be treated so as to give a right to every person injured by them to demand relief’ (per Atkin J., at 580). See also *Caparo v. Dickman* re proximity.

⁷⁴⁸ *Cassa di Risparmio della Repubblica di San Marino SpA v Barclays Bank Ltd* [2011] EWHC 484 (Comm) at 263. This authority ruled that ‘if any representation was made it was one of opinion and/or expectation and/or belief’ (per Hamblen J., at 267). It has been noted that ‘the judgment adds to the established line of cases in which the courts have demonstrated their willingness to uphold arranging banks’ no representation and no duty of care disclaimers, where they are properly incorporated and drafted, against sophisticated claimants with the consequence that the claimant can be contractually estopped from pursuing a claim for negligent misrepresentation’. See Damien Byrne-Hill, Simon Clarke, Stephen Flaherty, Harry Edwards and Eleanor Lamberton, ‘Cassa di Risparmio della Repubblica di San Marino S.p.A. v Barclays Bank Ltd: when is a AAA rating more than a AAA rating?’, Herbert Smith Freehills LLP e-bulletin, 31 March 2011, 2.

⁷⁴⁹ *JP Morgan Chase Bank v Springwell Navigation Corp* [2008] EWHC 1186 (Comm).

product he is trying to sell. However, in case of an advisory relationship between CRAs and investors, such comments (or opinions) will raise liability if these advices are negligent.⁷⁵⁰

A similar approach is found in *Titan Steel Wheels v RBS* where the English court placed particular attention on the distinction between giving advice or making recommendations and giving advice in an advisory capacity.⁷⁵¹ These rulings addressed the controversial questions of whether a duty was owed and what the scope of that duty should be, an approach that could open the doors for successful complaints against ratings agencies. In essence, it seems clear that the English courts are reluctant to recognise a liability for CRAs in absence of a duty of care to investors and in absence of a contractual relationship. Moreover, it would seem that *caveat emptor* still applies where the investor is a sophisticated one (see the *Cassa di Risparmio* case).

The following section focuses on the equitable doctrine of ‘estoppel’ as a possible solution for negligent misstatements by CRAs. The question is addressed as to whether estoppel could act as a deterrent for rating agencies’ misbehaviour and as a warning against inaccuracies in valuations.

4.3 *The doctrine of estoppel as a possible solution to negligent misstatements by CRAs*

In order to design an adequate liability system for CRAs, the doctrine of estoppel could be taken into account as an option to avoid negligent misleading ratings. In particular due consideration is given to estoppel by representation (or estoppel by conduct) in which ‘the mere fact that a person is precluded from denying the truth of something he has said does not involve him in any liability’.⁷⁵² In other words, CRAs could be potentially liable under the doctrine of estoppel—the assumption that the statement was true, and where the promise is intended to create legal relations giving the promise a cause of action in damages.⁷⁵³ If CRAs claim that they issue a simple opinion of the

⁷⁵⁰ Harry Edwards, ‘Liability for the rating and sale of structured credit products: Australian cases and their (much) wider implications’ (2013) 7 *Law and Financial Markets Review* 2, 93.

⁷⁵¹ *Titan Steel Wheels v RBS* [2010] EWHC 211 (Comm).

⁷⁵² Guenter Treitel, *Some Landmarks of Twentieth Century Contract Law* (Oxford: OUP 2002) 38.

⁷⁵³ *Pickard v Sears* [1837] 6 A. & E. 469 and *Freeman v Cooke* [1848] 2 Ex. 654. In the literature, see Elizabeth Cooke, *The Modern Law of Estoppel* (Oxford: OUP 2000) 17 and 62.

creditworthiness of an issuer, this type of opinion—resulting in a wrong belief—could be analysed as falling within the doctrine of ‘equitable estoppel’.⁷⁵⁴ The question arises as to whether detrimental reliance on ratings could be dealt with under the ‘estoppel rule’ as affording a measure of accountability for inaccurate evaluations.

Also, the question is whether losses suffered by investors could give rise to a private right of action and an award of damages because ratings induced the third parties reasonably to invest in highly rated securities.

Estoppel is an equitable doctrine.⁷⁵⁵ The origin of the ‘estoppel principle’ derives from Lord Denman’s judicial opinion in *Pickard v Sears* in 1837 and *Freeman v Cooke* in 1848 where it was concluded that ‘where one, by his words or conduct, wilfully causes another to believe in the existence of a certain state of things, and induces him to act on that belief, or to alter his own previous position, the former is precluded from averring against the latter a different state of things as existing at the same time’.⁷⁵⁶

In *Jorden v Money*, the court held that estoppel can only arise from statements of fact and not from promises, so that the estoppel rule cannot be used to enforce promises.⁷⁵⁷ Subsequently, the principle of estoppel was raised in the judgment of

⁷⁵⁴ Kristofor W. Nelson, ‘Rough Waters for the Ratings Companies: Should the Securities Ratings Companies Be Held Liable for Investor Reliance in the Wake of the Real Estate Meltdown of 2007-2008?’ (2009) 63 *University of Miami Law Review* 4, 1178 and 1191. The author comments on an important judicial opinion (*Atlantic Masonry v Miller Construction*, 558 So. 2d 433, 434—Fla. 1st DCA 1990) in which is stated that ‘although the investors do not have a direct contractual relationship with the ratings companies, courts have held that third parties are entitled to relief under the doctrine of promissory estoppel’.

⁷⁵⁵ Jack Beatson, Andrew Burrows and John Cartwright, *Anson’s Law of Contract* (29th eds., Oxford: OUP 2010) 116-117.

⁷⁵⁶ *Pickard v Sears* [1837] 6 A. & E. 469. See also *Freeman v Cooke* [1848] 2 Ex. 654, 652. In this case, the court observed that a representation may be made either by statement or by conduct, and conduct may include negligence (at 664). By quoting Lord Denman’s opinion in *Pickard v Sears*, the court held that ‘the term “wilfully” must be understood if not that the party represents that to be true which he knows to be untrue, at least, that he means his representation to be acted upon, and that it is acted upon accordingly; and if whatever a man’s real intention may be, he so conducts himself that a reasonable man would take the representation to be true, and believe that it was meant that he should act upon it, and did act upon it as true, the party making the representation would be equally precluded from contesting its truth’; *Seton, Laing & Co. v Lafone* (1887) 19 QBD 68, where Lord Esher MR concluded that ‘one ground of estoppel is where a man makes a fraudulent representation and another man acts upon it to his detriment. Another may be where a man makes a false statement negligently, though without fraud, and another man acts upon it. And there may be circumstances under which, where a misrepresentation is made without fraud and without negligence, there may be an estoppel’ (at 70).

⁷⁵⁷ *Jorden v Money* (1854) 5 HLC 185. The court held that ‘if a person makes a false representation to another and that other acts on it the person who has made it will not afterwards be allowed to set up that what he said was false and to assert the truth in place of the falsehood which misled the other’. It was made clear that the doctrine of common law estoppel only applies

the House of Lords in *Hughes v Metropolitan Railway Co*,⁷⁵⁸ where it was ruled that estoppel operates as a defence to a claim.

The doctrine of estoppel was developed prominently in *Central London Property Trust Ltd v High Trees House* where Lord Denning held that parties could invoke the principle of promissory estoppel for asserting their legal rights.⁷⁵⁹ As Cooke has observed ‘estoppel is a consequence of someone’s words or behaviour, in virtually any context, but only where the words or behaviour have had an effect on someone else’.⁷⁶⁰ It is important to note that estoppel comprises several elements namely: (1) the statement to be acted on; (2) action on the faith of it; and (3) the detriment to the actor.⁷⁶¹

Generally, estoppel is a shield not a sword.⁷⁶² To what extent this is true depends on the jurisdiction. For example, English law does not permit estoppel to be used as cause of action, while jurisdictions such as the US and Australia do allow estoppel as a cause of action in certain circumstances.⁷⁶³

In *Combe v Combe*, the Court of Appeal affirmed that estoppel cannot act as a cause of action.⁷⁶⁴ Specifically, the Court ruled that promissory estoppel only prevents a party from insisting upon his strict legal rights when it would be unjust to allow him to enforce them, having regard to the dealings which have taken place between the parties. While estoppel by representation is commonly

to statements of existing facts and not to representations of future intention or promises.

⁷⁵⁸ *Thomas Hughes v The Directors, &C., of the Metropolitan Railway Company* (1877) 2 App. Cas. 439.

⁷⁵⁹ *Central London Property Trust Limited v High Trees House Limited* [1947] K.B. 130. The court held that ‘estoppel applies to promises, not representations of fact’.

⁷⁶⁰ Elizabeth Cooke, *The Modern Law of Estoppel* (Oxford: OUP 2000) 17 and 62. The author observes that ‘reliance is a pervasive precondition for estoppel, and this is usually described as detrimental reliance’.

⁷⁶¹ *Canada and Dominion Sugar Company Ltd. v Canadian National (West Indies) Steamships Ltd* [1947] AC 47, PC at 56.

⁷⁶² Specifically, where the estoppel is by representation, no cause of action arises as a result. See *Low v Bouverie* [1891] 3 Ch. 82. In *Derry v Peek* [1889] 14 App. Cas. 337, the Court of Appeal stated that ‘estoppel is only a rule of evidence; you cannot found an action upon estoppel. Estoppel is only important as being one step in the progress towards relief on the hypothesis that the defendant is estopped from denying the truth of something which he has said’.

⁷⁶³ Consequently, English courts are not required to determine the measure of damages for breach of an estoppel. See George Spencer-Bower, *The Law Relating to Estoppel by Representation* (4th ed., Lexis Nexis UK 2004) 516-518. See also *Grundt v Great Boulder Pty Gold Mines Ltd* (1937) 59 C.L.R. 641 HCA, where the judge noted that sometimes parties to a deed deliberately set out what he called a ‘hypothetical state of affairs’ in order to create a ‘mutual estoppel’. See also *Waltons Stores (Interstate) Ltd v Maher* [1988] 164 CLR 387, where the Australian High Court pointed out that “equitable estoppel complements the tortious remedies of damages for negligent misstatement or fraud and enhances the remedies available to a party who acts or abstains from acting in reliance on what another induces him to believe” (at 427).

⁷⁶⁴ *Combe v Combe* [1951] 2 K.B. 215, 219.

considered a shield, proprietary estoppel—that arises where there is no actual promise at all—can create a cause of action.⁷⁶⁵

The doctrine of ‘promissory estoppel’ causes difficulty for parties who have to prove that they would have acted differently in the absence of the promise. On this view, promissory estoppel cannot be used against credit rating agencies that issue a statement of facts (or informed opinions) and not promises. For this reason, due consideration should be given to other forms of estoppel namely ‘estoppel by representation’ or ‘estoppel by conduct’.⁷⁶⁶

The next section discusses the relevance of estoppel as a cause of action. It also examines how estoppel by representation differs from the tort of misrepresentation and how a representation by a CRA meets the requirement that estoppel by representation must relate to facts.

4.4 Estoppel by representation and the tort of misrepresentation

The ‘estoppel’ doctrine, particularly estoppel by representation (or estoppel by conduct), generally arises ‘from a misrepresentation of fact made to an innocent person upon the faith of which and as a reasonable consequence of which he changes his position to his prejudice’.⁷⁶⁷

Estoppel by representation refers to an unequivocal representation as to fact or a mixture of fact or law, upon which the other party has relied, and changed his position so that it would be to his detriment if the representation were incorrect. It has been observed that ‘a representation must be of an existing fact, not of a mere intention, nor of a mere belief [where] the representation of an existing state of things as being of a continuous nature is, however, more than a statement of intention, and a person who has made the representation cannot, after ridding himself of that state of things, take advantage of its removal to the prejudice of another who has acted on the representation’.⁷⁶⁸

⁷⁶⁵ *Crabb v Arun District Council* [1976] Ch. 179, where the court made clear that ‘an estoppel may have the effect that a party can enforce a cause of action which, without the estoppel, he would not be able to do’.

⁷⁶⁶ A first application of the ‘estoppel by conduct’ is found in *Lickbarrow v Mason* [1787] 2 TR 63, 100 ER 35. See Lord Halsbury in *Henderson v Williams* [1895] 1 QB 521; *Pickering v Busk* [1812] 15 East 38; *Boyson v Coles* [1817] 6 M. & S. 14; *Spear v Travers* [1815] 4 Camp. 251; *Martini v Coles* [1813] 1 M. & S. 140.

⁷⁶⁷ A. L. Pickering, ‘Estoppel by Conduct’ (1939) 55 *Law Quarterly Review* 3, 407. See also Lord Tomlin in *Greenwood v Martins Bank* [1933] AC 51 and *Thompson v Palmer* [1933] 49 CLR 507.

⁷⁶⁸ See Halsbury’s *Laws of England*, ‘Estoppel’ (5th eds., LexisNexis 2014) 47(4) para 380.

Further, estoppel by representation entails that a person who has given an acknowledgement/representation of non-reliance is prevented from subsequently asserting against the party to whom the representation was given that it is not true. Crucially, there is a need to prove reliance by the party asserting the estoppel. The representor is permanently prevented from averring or proving facts which are contrary to the representation.

In *Avon County Council v Howlett*, the UK courts affirmed that estoppel by representation requires satisfaction of the ‘three-limb test’: (a) the statement is clear and unambiguous; (b) the plaintiff meant it to be acted upon by the defendant, or, at any rate, so conducted himself that a reasonable man in the position of the defendant would take the representation to be true and believe that it was meant that he should act upon it; and (c) the defendant did in fact believe it to be true and was induced by such belief to act upon it—when entering into sale and purchase or investment transactions.⁷⁶⁹

In tort actions for misrepresentation, it is generally considered that the defendant’s liability turns on whether he owed a duty of care to the claimant, and that in turn may depend largely upon whether he ought to have foreseen that the statement would be acted upon the claimant.⁷⁷⁰

What seems important in this discussion is that a person was induced to rely on statements or promises made by other parties.⁷⁷¹ However, mere statements of intention are distinct from promises especially when the representation of fact does not cause harm and does not induce detrimental reliance and therefore is not suitable for protection.⁷⁷²

In *Amalgamated Investment and Property Co Ltd v Texas Commerce International Bank Ltd*, the court pointed out that in absence of a contractual relationship the representation produced a belief or expectation in the mind of the representee or confirmed or strengthened a belief which he already held.⁷⁷³

⁷⁶⁹ See *Avon County Council v Howlett* [1983] WLR 603 and *Lowe v Lombank Limited* [1960] 1 WLR 196 (CA).

⁷⁷⁰ See *Yianni v. Edwin Evans & Sons* [1982] Q.B. 438; *Standard Chartered Bank v. Pakistan National Shipping Corp.* [1995] 2 Lloyd’s Rep. 365.

⁷⁷¹ See *Re Lehman Brothers International (Europe)* [2011] EWCA Civ 1544, [2012] 2 BCLC 151.

⁷⁷² Michael Pratt, ‘Identifying the Harm Done: a Critique of the Reliance Theory of Estoppel’ (1999) 21 *Adelaide Law Review* 2, 209-210.

⁷⁷³ *Amalgamated Investment and Property Co Ltd v Texas Commerce International Bank Ltd* [1982] QB 84 at 104-105, where the court held that ‘there may be cases where the representee has proceeded initially on the basis of a belief derived from some other source independent of the representor, but his belief has subsequently been confirmed by the encouragement or

The effect of estoppel by representation—as a defence not as a cause of action—in credit ratings could prevent the agencies from denying, or going back on what they said in their ratings. In other words, estoppel by representation may be used as a rule of evidence to demonstrate that the rating represented an informed statement of fact based on internal methodologies upon which investors relied; and to prevent the CRAs from claiming that rating is a mere opinion about the creditworthiness of financial products. In particular, the doctrine of estoppel by representation could be invoked against CRAs in order to protect consumers' expectation interest.⁷⁷⁴ In this way, estoppel by representation is applicable because of the detrimental reliance of investors, that is to say, because the representees have relied upon the CRAs' representation to their detriment.⁷⁷⁵

At this point the question is whether the disappointed party would be able to claim both reliance damages and expectation damages under estoppel by representation.⁷⁷⁶

Assuming that the CRA has made a representation to investors in the form of an assessment of financial products with the result that investors are induced on the strength of that representation to change their investment decisions to their detriment, the agency could be estopped from making any averment substantially at variance with its former representation, if the investors object thereto.⁷⁷⁷

If estoppel is used to protect persons who reasonably and detrimentally rely on the representations of others, CRAs could be held potentially liable under the estoppel by representation (but not if estoppel is only a shield to defend a claim) for their inaccurate assessment vis-à-vis investors. The fact that CRAs provide a public statement (or 'mere opinion') relating to financial products causes legal effects to attach to consumers' expectations.⁷⁷⁸ For this reason CRAs should owe

representation of the representor'. Lord Brandon stated that 'a party cannot in terms found a cause of action upon an estoppel, but he may, as a result of being able to rely on an estoppel, succeed on a cause of action on which, without having been able to rely on that estoppel, he would have failed' (at 86).

⁷⁷⁴ M. P. Thomson, 'From Representation to Expectation: Estoppel as a Cause of Action' (1983) 42 *Cambridge Law Journal* 2, 266-269. See also Elizabeth Cooke, 'Estoppel and the protection of expectations' (1997) 17 *Legal Studies* 2, 285.

⁷⁷⁵ Alfred T. Denning, 'Recent Developments in the Doctrine of Consideration' (1952) 15 *The Modern Law Review* 1, 9.

⁷⁷⁶ Andrew Robertson, 'Reliance and Expectation in Estoppel Remedies' (1998) 18 *Legal Studies* 3, 368.

⁷⁷⁷ Michael Spence, *Protecting Reliance: The Emergent Doctrine of Equitable Estoppel* (Hart Publishing 1999) 20.

⁷⁷⁸ Supposing that there are two market participants, A and B, that A (for instance, a CRA)

a duty to take reasonable care that the statement is correct. In this regard, it has been noted that ‘before a person can be estopped by a representation inferred from negligent conduct, there must be a duty to use due care towards the party misled or towards the general public of which he is a member’.⁷⁷⁹

It is important that the representation must determine a relevant alteration of investors’ decisions. However, it is a difficult task for investors to show that their expectations were affected by inaccurate ratings at the time when the investment decision was taken.

In this context, there has been some debate whether estoppel by representation requires proof of detriment in the very acts undertaken in reliance upon the representation. According to Spencer-Bower and Turner ‘the detriment need not be of a character sounding in damages if it amounts to an unfairness that equity would recognise and remedy’.⁷⁸⁰ Another scholar argues that the detriment consists ‘in any loss that the party arguing the estoppel suffered because the assumption upon which he had relied proved unjustified’.⁷⁸¹

In *National Westminster Bank plc v Somer International (UK) Ltd*, the Court of Appeal considered estoppel by representation as a rule of evidence ‘the consequence of which is simply to preclude the representor from averring facts contrary to his own representation’.⁷⁸² The Court of Appeal made it clear that estoppel by representation ‘differs from the position in the case of so-called “equitable” or “promissory” estoppel in respect of which a specific promise to waive or refrain from enforcing rights may be withdrawn on reasonable notice and in “proprietary” estoppel, where when giving effect to the interest or right in property which the party raising the estoppel asserts, the court assumes a wide discretion as to the terms on which such relief is granted’.

represents to an investor of financial products (B) that those products are of a high quality, when they are not. Although A may be estopped from denying the truth of that statement that does not make him liable to the investor and in this sense the estoppel does not give rise to a cause of action. In this case, rating agency A might, if he were negligent, be liable for misrepresentation; but that liability is based on the fact that the statement was *false* while any liability by estoppel would be based on the opposite assumption, i.e. that the statement is *true*. See on this example Guenter Treitel (note 752) 35.

⁷⁷⁹ Halsbury’s Laws of England (note 768).

⁷⁸⁰ George Spencer-Bower, *The Law Relating to Estoppel by Representation* (4th eds., Lexis Nexis UK 2004) 116.

⁷⁸¹ Michael Spence (note 777) 44-45.

⁷⁸² *National Westminster Bank plc v Somer International (UK) Ltd* [2002] QB 1286. See also the arguments of Lord Wright in *Canada and Dominion Sugar Co Ltd v Canadian National (West Indies) Steam Ships Ltd* [1947] AC 46, where estoppel is considered to be a substantive rule of law.

In other words, ‘once the representation has been acted on to the detriment of the transferee the contrary may not be asserted’.⁷⁸³ In this view, estoppel may be applied to rating agencies evaluations as a rule of evidence in terms of establishing a fact necessary to complete a cause of action or demolishing a defence thereto. In substance, estoppel by representation may be applied where CRAs might seek to deny their evaluations in case of faulty ratings.

As just indicated, estoppel is not used for the direct enforcement of promises or representation of facts. Consequently, estoppel cannot by itself entitle a claimant to a remedy for a factual situation. This means that estoppel cannot be used to obtain a remedy for a misstatement.

Other questions seem relevant in this discussion: (1) to what extent do CRAs reasonably foresee that their credit ratings will be relied upon by investors; and (2) to what extent would reliance on the part of investors be reasonable.

It has been noted that ‘reliance is a form of relationship-specific investment’.⁷⁸⁴ Consequently, reliance always involves some risk to the relying party. The reliance measure puts the injured party in as good a position as if the contract had never been made. Reliance on CRAs’ ratings may turn out to be a wise decision, if nothing goes wrong and the transaction is executed, but it will turn out to be unwise if the ratings prove to be inaccurate and misleading.⁷⁸⁵ Further, reliance on a CRA’s evaluation may bind the CRA only if the evaluation is one in respect of which the CRA should induce reliance on the part of the issuer.

In the light of the above considerations, the estoppel rule with its features and limitations might not be a feasible way of making CRAs accountable because of its limitations as an equitable shield rather than a sword; however, the estoppel rule could be treated as a deterrent for CRAs’ misstatements.

Finally, I submit that to extend liability for misrepresentation under *Hedley Byrne*, etc. so as to make it into an active remedy (a sword and not merely a shield) in the limited case of CRAs would be perfectly possible and indeed desirable on the basis of the need to implement the UK’s obligations under EU law. It is trite law that he who comes to equity must come with clean hands. It can

⁷⁸³ *National Westminster Bank plc v Somer International (UK) Ltd* [2002] (note 782) at 35.

⁷⁸⁴ Richard Craswell, ‘Offer, Acceptance, and Efficient Reliance’ (1996) 48 *Stanford Law Review* 3, 490.

⁷⁸⁵ *ibid* 502.

therefore be said that this would avoid potentially opening the floodgates by extending the scope of the tort of negligence or by creating a new statutory tort where the discretionary nature of the action would have to be spelled out, possibly tying the courts' hands in an undesirable way.

After providing an analysis of the generic grounds of liability such as contract, tort, fiduciary duty, estoppel and statutory right of action as a possible option to hold CRAs liable for flawed ratings, the next chapter examines the implementation of these forms of liability in the US, the UK, the EU and Australia. It also discusses recent developments in the case law and the main debate about the type of liability which can be attached to them in order to enhance their responsibility vis-à-vis investors.

Chapter Five

The liability regime of credit rating agencies in the US, the UK, the EU and Australia

5.1 The perspective of professional liability for CRAs in the US, the UK and the EU regulatory framework

This chapter discusses the regulatory intervention which has been adopted in order to strengthen the accountability regime for CRAs in response to the shortcomings which the 2007-2009 financial crisis brought to light. It also explores the development of case-law by taking into account the position of courts under the US, the UK, the EU and Australian legislation.

What is crucial for the operation of the legal protection for investors is the soundness of CRAs' actions in interpreting disclosed information and assessing the creditworthiness of companies, thereby increasing investor confidence. However, the behaviour of rating agencies and issuers may be exacerbated in CRAs' activities where there are different parties with different interests in the outcome of transactions.⁷⁸⁶

It seems paradoxical that CRAs should be viewed as information intermediaries intended to protect public investors when they enjoy a different regulatory treatment compared with other financial experts (such as auditors and financial analysts).⁷⁸⁷

⁷⁸⁶ In *King County, Washington et al v IKB Deutsche Industriebank AG et al* U.S. District Court, Southern District of New York, No 09-08387 [4 May 2012], it was claimed that S&P continued to hand out gold-plated triple A credit ratings to debt securities in order to win fees even though they were aware that risks were building up in the underlying subprime mortgages. S&P filed a motion to dismiss the claim of the US Department of Justice, arguing that the agency's inability to predict 'the most catastrophic meltdown since the Great Depression reveals a lack of prescience but not fraud'. The court refused to dismiss claims by two institutional investors against Moody's, S&P's and Fitch that fraudulently misrepresented the value of the structured investment vehicle by assigning high credit ratings to the Senior Notes. After issuing a high grade, the credit rating agencies downgraded the Senior Notes to 'junk' status and as a result, those holding the notes suffered damages. See Stephen Foley, 'Standard & Poor's and Moody's settle US subprime lawsuits' *Financial Times* (London, 27 April 2013).

⁷⁸⁷ Generally, auditors preparing company accounts owe a duty of care to any person whom they ought reasonably to have foreseen might rely on the accounts. See *JEB Fasteners Ltd v Marks Bloom & Co* [1981] 3 All E.R. 289. This case showed that in absence of the necessary degree of proximity it is difficult to establish a duty of care between the parties.

As information gatekeepers, CRAs supply reliable information about the riskiness of investments that serves to increase the credibility of issuer disclosure and to improve the efficiency of resources allocation in the financial markets. But the information provided by rating agencies is only credible if they retain a minimum level of independence. As a result, they should have an obligation to ensure that the ratings they assign are accurate. CRAs act as professionals in the financial markets.⁷⁸⁸ However, the key question is whether the third party can reasonably, and may foreseeably, rely on the opinion or information provided by “rating” professionals.⁷⁸⁹

It seems contradictory that the CRAs, on the one hand certify the quality of the product but, on the other hand are not liable for the quality of their ratings in the way that other gatekeepers—such as auditors—are liable for the opinions they provide to investors and other stakeholders.⁷⁹⁰ CRAs should be held to account if they are negligent in formulating the ratings as their responsibility comes from the information service they provide. However, the disclaimers inserted in the ratings report attached by CRAs (see ‘Appendix IV’) create *de facto* a virtual immunity for opinions that are ‘investment advice on which reliance could and should be placed’.⁷⁹¹

Unlike auditors, CRAs do not conduct factual verification with respect to the information provided to the market.⁷⁹² CRAs are paid for the initial ratings, but not for surveillance and further upgrades or, more importantly, downgrades. Unlike auditors, CRAs are not obliged to conduct an internal rotation where their services are used by the same client for successive years. In addition, CRAs provide their financial assessments to non-clients, i.e. unsolicited ratings, even if

⁷⁸⁸ Article 3(1)b of the 2009 CRA Regulation that states ‘CRA means a legal person whose occupation includes the issuing of credit ratings on a professional basis’.

⁷⁸⁹ Where a CRA undertakes to provide opinion or information for an issuer (company) knowing that the issuer intends to use that information or evaluation to induce a third party to act in a manner which will be to his detriment if the professional is negligent, the professional may owe a duty to the third party. See *Royal Bank of Scotland Plc v Bannerman Johnstone Maclay* [2005] CSIH 39; 2005 1 S.C. 437.

⁷⁹⁰ Patrick C. Leyens, ‘Auditor’ in Jurgen Basedow, Klaus J. Hopt, Reinhard Zimmermann and Andreas Stier (eds.), *The Max Planck Encyclopedia of European Private Law*, Vol. I (Oxford: OUP 2012) 85-88.

⁷⁹¹ ‘Holding the rating agencies to account’ *Financial Times* (London, 5 November 2012).

⁷⁹² However, the corporate scandals of Enron and WorldCom have demonstrated auditors’ failure to detect irregularities in companies’ financial statements. See Nicole B. Neuman, ‘A “Sarbanes-Oxley for Credit Rating Agencies? A Comparison of the Roles Auditors’ and Credit Rating Agencies’ Conflicts of Interests Played in Recent Financial Crises’ (2010) 12 *University of Pennsylvania Journal of Business Law* 3, 930.

they have no access to the management or to internal due diligence of the firms concerned.⁷⁹³

In common with auditors, CRAs are largely dependent on their reputation and reliability gained among market participants. In common with auditors, CRAs have technical expertise in understanding the financial profiles of the firms they assess and are paid by the clients they evaluate, but their ‘opinions’ are subject to different regulatory treatment.⁷⁹⁴ In this context, one commentator at least considers that ‘CRAs “opinions” are no different from the “opinions” of other gatekeepers’.⁷⁹⁵

CRAs have a powerful role with regard to the access of issuers to capital and it seems to be a logical consequence that they should be regulated with due regard to this role.⁷⁹⁶ As indicated, it is paradoxical to consider CRAs’ function as that of journalists given their involvement in business operations with issuers. CRAs are not simply analysing and rating debt securities for a journalistic function, they are being paid to do so by the issuers of debt securities. Debt securities rating is a substantial and profitable business and agencies’ ratings are opinions that carry commercial weight and are referenced by financial institutions.⁷⁹⁷

CRAs generally play an active role in transactions by structuring the debt offering and by helping to design and sell a financial product. Generally, investors are unaware that the rating agencies help issuers construct the very financial instruments they eventually judge.⁷⁹⁸ CRAs provide ratings as a certification or benchmark for investors that enter in the market, but they also play an advisory role in securities transactions. In this respect, it would be normal to consider professional liability for CRAs in the shape of a ‘strict liability standard under

⁷⁹³ Soku Byoun and Yoon S. Shin, ‘Unsolicited Credit Ratings: Theory and Empirical Analysis’ (2002) Financial Management Association Annual Meeting, Working Paper, 3-5.

⁷⁹⁴ Iris H-Y Chiu, ‘The role and liabilities of auditors in financial regulation: addressing the “expectations gap” (2012) *International Business Law Journal* 5, 545.

⁷⁹⁵ Frank Partnoy, ‘How and Why Credit Rating Agencies Are Not Like Other Gatekeepers’ (2006) University of San Diego, Legal Studies Research Paper No 07-46, 96.

⁷⁹⁶ Patrick C. Leyens, ‘Rating Agency’ in Jurgen Basedow, Klaus J. Hopt, Reinhard Zimmermann and Andreas Stier (eds.), *The Max Planck Encyclopedia of European Private Law*, Vol. II (Oxford: OUP 2012) 1412-1413.

⁷⁹⁷ John Gapper, ‘Rating agencies must beware of the law’ *Financial Times* (London, 6 February 2013).

⁷⁹⁸ Lisbeth Freeman ‘Who’s guarding the gate? Credit-Rating Agency liability as “Control Person” in the Subprime Credit Crisis’ (2009) 33 *Vermont Law Review* 3, 593.

which behaviour is assessed according to objective standards, i.e. norms developed in the specific sector'.⁷⁹⁹

However, the professional liability standard only works where there is a contractual relationship between parties: as already discussed, CRAs are able to bypass this concern by using the legal impediment that investors are not their clients. What is more, it is difficult to prove that a CRA has negligently committed an error in applying a given rating methodology rather than another. CRAs have a direct impact on the markets and for this reason they should provide an appropriate rating of the debt liability and chances of default owing to their duty to market, and be liable for any faulty assessment.⁸⁰⁰

In the US, the Dodd-Frank Act introduced specific rules (sections 931-939H) regulating the position of CRAs.⁸⁰¹ In particular, section 931(3) of the Dodd-Frank Act provides that, by performing evaluative and analytical services on behalf of clients (that are fundamentally commercial in character), CRAs should be subject to the same standards of liability and oversight as those applying to auditors, securities analysts, and investment bankers.⁸⁰² The Dodd-Frank Act does not regard CRAs as 'investment advisers', although the value of credit ratings is recognized by the reference to liability standards similar to those applicable to other information intermediaries.⁸⁰³

In the EU, the MiFID Directive⁸⁰⁴ does not regard the services of CRAs as 'investment advice' either, on the basis that a rating is not covered by Article 4(4)

⁷⁹⁹ Vibe Ulfbeck, 'Civil liability of Credit Rating Agencies – A professional liability regime?' in Jan Kleineman, Lars Gorton and Aron Verständig (eds), *Perspectives on Credit Rating Agencies* (Stockholm: Författarna, Stockholm Centre for Commercial Law Jure Förlag AB 2013) 310-311. The author draws an analogy from accountancy, underlining the similarity of the roles of the accountant and the CRA: however, 'the accountant must—by law—act as a trustworthy representative of the public. No similar obligation applies by law to the CRAs'.

⁸⁰⁰ Sam Jones, 'Moody's error gave top ratings to debt products' *Financial Times* (London, 21 May 2008).

⁸⁰¹ Title IX, Subtitle C of the Dodd-Frank Act "Improvements to the Regulation of Credit Rating Agencies".

⁸⁰² Section 931(3) of the Dodd-Frank Act notes that 'because credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial "gatekeepers" do, the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers'.

⁸⁰³ Allana M. Grinshteyn, 'Horseshoes and hand grenades: The Dodd-Frank Act's (Almost) Attack on Credit Rating Agencies' (2011) 39 *Hofstra Law Review* 4, 972-973. The author observed that 'although the statutory provisions creating a cause of action against credit rating agencies are likely to meet resistance in the courts, such provisions at the very least enhance the credit rating agencies' exposure to liability' (at 956).

⁸⁰⁴ Directive 2004/39/EC replaced by Directive 2014/65/EU.

of MiFID.⁸⁰⁵ In principle, it seems that CRAs are out of reach of the Directive in that respect. Notwithstanding this, CRAs which do offer ‘investment services’, as defined by Annex I of that Directive, on a professional basis, need to seek authorization from the relevant home state authority.⁸⁰⁶

Credit rating is inherently subjective and reflects professional judgement.⁸⁰⁷ It is noteworthy that intermediary duties essentially derive from professional standards and from securities regulation. In a contractual relationship, the intermediary duties arise from the decision to enter into a contract.

In *Caparo Industries Plc v Dickman*, the House of Lords held that the auditor owes a duty to the company and not to investors on the ground of its contractual relationship with the firm.⁸⁰⁸ This authority established a legal principle for determining the existence of a duty of care: (1) whether the damage is reasonably foreseeable; (2) whether there is a relationship of proximity between claimant and defendant; and (3) whether it is just and reasonable to impose a duty.

⁸⁰⁵ According to Article 4(4) of MiFID ‘Investment advice’ means the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments’. See on this matter Harry McVea, ‘Credit rating agencies, the subprime mortgage debacle and global governance: the EU strikes back’ (2010) 59 *International & Comparative Law Quarterly* 3, 716.

⁸⁰⁶ Section A of Annex I (‘Investment services and activities’) to the MiFID Directive. Closer examination of the text suggests that MiFID is applicable only to credit rating agencies undertaking investment services and activities over and above their regular credit rating activity. For example, if a CRA provides investment services (such as investment advice) to clients that fall under MiFID, the provisions on conflicts of interest apply to protect the interest of those who receive these services. See the Communication from the Commission on Credit Rating Agencies (OJ 2006 C 59, p. 2), Section 3.1 (‘EU Legislation’).

⁸⁰⁷ Mark Carl Rom, ‘The Credit Rating Agencies and the Subprime Mess: Greedy, Ignorant, and Stressed?’ (2009) 69 *Public Administration Review* 4, 641.

⁸⁰⁸ *Caparo Industries Plc v Dickman* [1990] 2 AC 831. The court held that there will be no liability in tort for negligent misrepresentation unless the maker of the statement knew that the statement would be communicated to the person relying on it specifically in connection with a particular transaction or a transaction of a particular kind. The limitation of a liability regime in the presence of sufficient proximity between the auditors and the shareholder is made clear in *Stone & Rolls v Moore Stephens* [2009] 1 A.C. 1391, where the House of Lords held that a wider remit of care was owed to creditors.

The principle that the auditor can owe the company an implied contractual duty of care for the inaccurate performance of the audit or may be accused of negligence and could potentially be liable for damages was also underlined in *Equitable Life Assurance Society v Ernst & Young* [2003] EWCA Civ 1114 and *Barings Plc v Coopers & Lybrand (No.7)* [2003] Lloyd’s Rep I.R. 566 cases. In academic circles, see Paolo Giudici, ‘Auditors’ multi-layered liability regime’ (2012) 13 *European Business Organization Law Review* 4, 523-524; Michael Paterson, ‘Reform of the law on auditors’ liability: an assessment’ (2012) 23 *International Company and Commercial Law Review* 2, 55; Alistair Alcock, ‘House of Lords revisits auditors’ liability’ (2010) 5 *Journal of Business Law*, 453-454.

CRAAs frequently argue that they are not party to any contractual relationship with investors but only with issuers.⁸⁰⁹ As a result, the relationship is between the CRAAs and the companies that request the security rating. Rating agencies, on the one hand, stand in a contractual relationship to the issuer; on the other hand, they stand in a relationship to investors which is of a non-contractual nature.

However, the issuer-CRA relationship raises questions on the part of investors. In particular, issuers (principals) without sufficient information or expertise to implement their preferences employ agents (rating agencies) which possess such expertise. Unless constrained (for example by proper liability) agents may be able to exploit their discretion so as to advance their own interests, rather than those of their principal. Still, the agent may sacrifice the best interests of both investors and issuers for the agent's own personal self-interest.

In performing their role of gatekeepers, CRAAs may be concerned to further their interests in relation not only to issuers, but also to investors. The CRAAs should act in the public interest and not in their own interest.⁸¹⁰ The larger problem, however, has to do with the weakness of the incentives that motivate the CRAAs when playing a gatekeeper role. The weakness concerns reputational improvement and investment controls.⁸¹¹

Most importantly, regulation exempts credit rating agencies from liability and courts tend to accept the CRAAs' argument that ratings are financial predictions.⁸¹² However, courts should recognize the active role of credit rating agencies in structuring the deal with issuers and should apply the professional liability degree

⁸⁰⁹ Raymond W. McDaniel, 'Roundtable on Credit Rating Agencies', Statement before the United States Securities and Exchange Commission, New York, 15 April 2009, 4-5.

⁸¹⁰ The US Department of Justice (DoJ) alleged that S&P's falsely told investors that its ratings were objective when instead they were influenced by a desire to win fees and market share. The DoJ charged S&P's with intentionally making 'limited, adjusted and delayed updates' to its rating criteria and analytical models during a key period between 2004 and 2007. In this case, S&P affirmed that its ratings are 'predictions about how securities might perform in the future'. The agency also argued that the decision-making process was inherently subjective rather than intentionally fraudulent and that the decision to invest was ultimately the responsibility of the buyer. See Kara Scannell and Stephen Foley, 'S&P asks court to throw out \$5bn lawsuit' *Financial Times* (London, 22 April 2013); 'Free speech or knowing misrepresentation?' *Economist* (New York, 5 February 2013); Stephen Foley and Kara Scannell, 'S&P moves closer to Geithner deposition' *Financial Times* (London, 16 April 2014).

⁸¹¹ Scott J. Boylan, 'Will credit rating agency reforms be effective?' (2012) 20 *Journal of Financial Regulation and Compliance* 4, 365.

⁸¹² As discussed, the CRAAs frequently argue that their ratings are mere financial opinions protected by the First Amendment of US Constitution that provides for freedom of speech.

for their ‘professional opinions’.⁸¹³ Consequently, CRAs should be held liable if their professional evaluations are found inaccurate.

CRAs should improve the incentives to supply complete available information to market participants. As has been noted, ‘credit rating agencies should not be punished merely because their ratings turn out to be “wrong”, rather, they should be held accountable for failure to make a good faith effort to calculate a reasonably accurate assessment of default risk using relevant and impartial data’.⁸¹⁴

It is possible to argue that CRAs should be treated in the same way as other financial intermediaries (auditors and financial analysts) by recasting their responsibilities in order to put them under professional duties entailing the requisite degree of care vis-à-vis investors.

After considering the perspective of professional liability by taking into account the possibility to consider CRAs subject to professional standards similar to those applicable to other information intermediaries such as auditors and financial analysts, the next section focuses on CRAs’ civil liability regime under US legislation.

5.2 *The rating agencies’ First Amendment protection in the United States*

It is generally considered that CRAs successfully escape accountability with respect to investors for inaccurate evaluations.⁸¹⁵ CRAs have been largely insulated from liability in the US for their assessments in part because of the protection afforded by the US Constitution—in particular the ‘freedom of speech’ enshrined in the First Amendment⁸¹⁶—and in part because of the protection given by statutes that ensured explicit immunities.⁸¹⁷

⁸¹³ Jonathan W. Heggen, ‘Not Always the World’s Shortest Editorial: Why Credit-Rating-Agency Speech Is Sometimes Professional Speech’ (2011) 96 *Iowa Law Review* 5, 1745.

⁸¹⁴ Benjamin H. Brownlow, ‘Rating Agency Reform: Presenting the Registered Market for Asset-Backed Securities’ (2011) 15 *North Carolina Banking Institute*, 137.

⁸¹⁵ In particular, the scholarly debate concentrated on when and whether CRAs should be liable for misrepresentations with respect to market participants. See Frank Partnoy, ‘Barbarians at the gatekeepers?: a proposal for a modified strict liability regime’ (2001) 79 *Washington University Law Quarterly* 2, 491.

⁸¹⁶ The First Amendment of US Constitution states: ‘Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the government for a redress of grievances’. The First Amendment protects bond ratings because they are categorised as ‘editorial communications’ and hence free speech. On this point, it should be

The US courts have long been reluctant to impose liability on credit rating agencies on the account of the difficulty to prove negligence or recklessness on the part of CRAs in making their evaluations (potential evidence of mistaken ratings is also problematic on account of the frequent changes in issuer's creditworthiness).⁸¹⁸

In their earlier judgments, courts mainly regarded CRAs as financial journalists on the ground of their ability to provide 'independent statements'.⁸¹⁹ In *New York Times Co. v Sullivan*, the US Supreme Court held that the First Amendment 'prohibits a public official from recovering damages for a defamatory falsehood relating to his official conduct unless he proves that the statement was made with "actual malice"—that is, with knowledge that it was false or with reckless disregard of whether it was false or not'.⁸²⁰

The US court based its decision on the account that 'erroneous statement is inevitable in free debate, and it must be protected if the freedom of expression is to have the "breathing space" that they need (...) to survive'.⁸²¹ This authority is relevant in order to comprehend the 'actual malice' standard for journalistic liability⁸²², and how courts protect rating agencies (for their opinions) on the ground that ratings touch upon matters of public concern.

The CRAs enjoyed protection on the account of the fact that the First Amendment to the US Constitution is interpreted by courts in the sense that rating is a 'free flow of ideas and opinions'. This line of argument was embraced in *First*

noted that the First Amendment does not protect the case of 'knowing misrepresentation'. See The Constitution of the United States of America as Amended (ordered pursuant to H. Con. Res. 190 as passed on July 25, 2007, 110th Congress, 1st Session).

⁸¹⁷ Section 11 of the Securities Act of 1933 ("Civil Liabilities on Account of False Registration Statement") that provides immunity from liability for misstatements in a registration statement if their ratings appear in a prospectus for a public offering of a security registered under that Act.

⁸¹⁸ The US courts held that agency ratings constitute protected commercial speech under the First Amendment. See *County of Orange v McGraw Hill Cos.*, 245 B.R. 151 (C.D. Cal. 1999); *Quinn v McGraw Hill Cos.*, 168 F.3d 331 (7th Cir. 1999); *In re Pan Am Corp.*, 161 B.R. 577, 581-83 (S.D.N.Y. 1993); *In re Scott Paper Co. Sec. Litig.*, 145 F.R.D. 366, 370 (E.D. Pa. 1992).

⁸¹⁹ Jonathan S. Sack and Stephen M. Juris, 'Rating Agencies: Civil Liability Past and Future' 238 *New York Law Journal* 88, 5 November 2007. First Amendment protection gave credit rating agencies the status of 'media journalist' and created the "exemption" to avoid liability among market participants. As a result, CRAs enjoyed immunity from negligent misrepresentation suits and were exempted from liability for mistakes in their ratings. See *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 511 F. Supp. 2d 742, 816-17 (S.D. Tex. 2005).

⁸²⁰ *New York Times Co. v Sullivan*, 376 U.S. 254 (1964) at 279-280.

⁸²¹ *ibid* at 280.

⁸²² The United States Supreme Court defined 'actual malice' as the proper standard for claims of defamation by public officials.

*Equity Corp. of Florida v Standard & Poor's Corp.*⁸²³, where the court recognised First Amendment protection for the rating agency, and *Jefferson County School District v Moody's Investor's Services, Inc.*⁸²⁴ where the court affirmed that credit rating agencies deserve constitutional protection because their ratings constitute the expression of opinions.

It is paradoxical that ratings obtain such protection even though their content does not consist of verifiable facts: the point is that rating agencies escape liability for the reliance that regulators place in them. The problem here is that credit rating agencies are virtually (legally) immune in the United States for the opinions they grant—treated as valuable and profitable statements—that influence the investment decisions of investors.⁸²⁵ This virtual immunity has increased the reputation of CRAs in the way that their success in civil suits has spread the perception of their ratings as infallible, with the result that their opinions are treated as reliable benchmarks for securities markets.⁸²⁶

In *Dun & Bradstreet, Inc. v Greenmoss Builders, Inc.*, the US Supreme Court established that the ‘actual malice’ standard applies only when the published material is a matter of public concern.⁸²⁷ The Court affirmed that speech motivated by the desire for profit is less deserving of First Amendment protection because ‘in any case the market provides a powerful incentive to a credit reporting agency to be accurate, since false credit reporting is of no use to creditors’.⁸²⁸

It should be noted that some judgments have refused to afford First Amendment protection to CRAs: in *In re International Business Machines*

⁸²³ *First Equity Corporation of Florida v Standard & Poor's Corporation*, 690 F. Supp 256 (S.D.N.Y. 1988), affd, 869 F.2d 175 (2d Cir. 1989).

⁸²⁴ *Jefferson County Sch. Dist. v Moody's Investor services, Inc.* [1999] No 97-1157.

⁸²⁵ Theresa Nagy, ‘Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation’ (2009) 94 *Minnesota Law Review* 1, 141-142.

⁸²⁶ Jonathan M. Barnett, ‘Certification Drag: The Opinion Puzzle and Other Transactional Curiosities’ (2007) 33 *The Journal of Corporation Law* 1,139. The author argued that ‘a credit rating can be viewed as a certification instrument that is provided by an issuer (through the third party rating agency) pursuant to the “constructive request” of the investor population (largely represented by agents in the form of money-managers and other investment fiduciaries)’.

⁸²⁷ *Dun & Bradstreet, Inc. v Greenmoss Builders, Inc.*, 472 U.S. 749 (1985), where the court held that a mistaken report that a business had filed for bankruptcy—which a credit reporting agency had distributed to only five subscribers—did not constitute a ‘matter of public concern’. The court stated that ‘when defamation against a private person did not involve a matter of public concern, presumed and punitive damages could be awarded even absent a showing of “actual malice”’. See in the literature Laura L. Saadeh, ‘Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.: The Supreme Court Further Muddies the Defamation Waters’ (1986) 20 *Loyola of Los Angeles Law Review* 1, 211.

⁸²⁸ *Dun & Bradstreet, Inc. v Greenmoss Builders, Inc.* (note 827) at 762.

Corporate Securities Litigation, where the court stated that ‘an opinion may still be actionable if the speaker does not genuinely and reasonably believe it or if it is without basis in fact’.⁸²⁹ In *In re National Century Fin. Enters., Inc., Inv. Litig.*, the court denied the Constitutional protection for credit rating agencies on the basis that ratings had been disseminated to a ‘select class of institutional investors’.⁸³⁰

The fact that CRAs have abrogated their responsibility as gatekeepers of credit risk should be analysed by understanding the nature of the ‘opinions’ they disseminate to financial markets. At first sight, there are two important questions: (1) to what extent do ‘simple opinions’ exercise a pervasive influence over the investment decisions of investors?; and (2) to what extent can CRAs be considered media reporters?

The relevant point is whether courts consider ratings as a matter of public concern. In this light, it can be asked whether ratings represent expressions of opinion or whether they constitute qualified evaluations about the creditworthiness of financial products.

As a matter of public concern, ratings involve a public matter on account of their function of supplying information to the securities markets by reducing the information costs and lowering the cost of capital. However, ratings activities concern a private matter on the account of the gatekeeper function performed by the CRAs. In other words, whether a rating is a matter of public concern depends upon how widely the rating was disseminated.

In this context, it is important to take into account the role of market discipline with respect to judicial oversight. It has been observed that ‘the very value of an agency’s ratings, like an accountant’s opinions lies in their independent, reliable evaluation of a company’s financial data’.⁸³¹ Although the reliability of CRAs has become the central issue in the recent public inquiry following the 2007-2009 financial crisis, the real question is: to what extent independent opinions give rise to liability vis-à-vis parties that place reliance on those opinions and suffer damage as a result?

⁸²⁹ *In re International Business Machines Corporate Securities Litigation*, 163 F.3d 102 (2d Cir. Nov. 17, 1998).

⁸³⁰ *In Re National Century Fin. Enter., Inc., Inv.*, 580 F. Supp. 2d 630 (S.D. Ohio 2008).

⁸³¹ Gregory Husisian, ‘What standard of care should govern the world’s shortest editorials? An analysis of bond rating agency liability’ (1990) 75 *Cornell Law Review* 2, 426. The author observed that ‘ratings are editorial opinions, published in letter form’ (at 454).

The fact that it is difficult to identify negligent behaviour in the ratings process has a bearing on the success of any civil suit. This aspect may encourage CRAs to issue inaccurate assessments and constitute a powerful disincentive for rating agencies not to make any assertions that investors can rely on. In terms of financial information, it may be argued that CRAs' activities should be regulated by attaching civil liability to their practice as result of the fact that investors buy products on the basis of the historical credit rating records of issuers.

The question of the potential civil liability of CRAs arose again following the decision in *Abu Dhabi Commercial Bank v Morgan Stanley & Co.* case where the court reaffirmed that rating agencies received robust First Amendment protection under 'typical circumstances' even though it denied such protection where agencies 'disseminated their ratings to a select group of investors'.⁸³²

In these factual circumstances, the courts treated ratings as commercial speeches. As result, they have conferred less protection on agencies' opinions and imposed a duty on rating agencies to investigate their claims conscientiously.⁸³³ Under the commercial speech head 'rating agencies would face civil liability where plaintiffs could show that agencies misled investors by consciously disregarding either the inaccuracy of or the methodology underlying their ratings, but not where plaintiffs could show only negligence'.⁸³⁴

In *Central Hudson Gas & Elec. Corp. v Pub. Serv. Comm'n*, the US Supreme Court held that a 'false and misleading commercial speech is not entitled to any First Amendment protection'.⁸³⁵ The Court concluded that CRAs do not perform normal journalistic functions and do not deserve the constitutional protections that are reserved for the press. This case showed that ratings cannot be considered mere opinions and CRAs cannot be regarded as traditional journalists on account of the remuneration arrangements existing between issuers and rating agencies.

⁸³² *Abu Dhabi Commercial Bank et al v Morgan Stanley & Co. et al* [2009] 651 F. Supp. 2d 155, 167 U.S. District Court, Southern District of New York (Manhattan), No. 08-07508. This authority ruled that ratings of securities that were distributed to a limited number of investors do not deserve the same free-speech protection as more general ratings of corporate bonds that were widely disseminated. For an academic commentary see Caleb Deats, 'Talk that isn't cheap: does the first amendment protect credit rating agencies' faulty methodologies from regulation?' (2010) 110 *Columbia Law Review* 7, 1819.

⁸³³ This case law changed the judicial perspective on CRAs' liability by opening the way to complaints against CRAs.

⁸³⁴ Caleb Deats (note 832) 1859.

⁸³⁵ *Central Hudson Gas & Electric Corp. v Public Service Commission*, 447 U.S. 557 (1980) at 557.

Therefore, the crux of matter is to define the term ‘opinion’ and consequently, to identify the nature of ratings. If a rating contains qualified evaluations on the creditworthiness of debt securities, it seems difficult to attach the status of ‘free-speech’ to such a rating. In addition, if ratings drive investment decisions on the account of their ‘certification role’ it seems difficult to consider them as being in the nature of press services.⁸³⁶ The US judiciary has not limited the latitude of ratings, a gap that reveals the uncertainty of decisions and shows the reluctance to hold CRAs accountable for their disappointing activities.

After having provided an overview of the First Amendment protection for CRAs in the US, the next section examines how CRAs successfully managed to escape civil suits on the base of the ‘financial reporters’ presumption and how the US courts are positively inclined to consider the CRAs’ journalistic disclaimers as a form of protection with respect to investors.

5.2.1 *The presumption of being ‘financial reporters’*

CRAs successfully avoid US lawsuits on the account of the fact that their evaluations are considered simple journalistic opinions of financial information disseminated to the public.⁸³⁷ These evaluations—as argued by the main CRAs—are in essence independent, objective opinions and not a guarantee and thus protected under the First Amendment of the US Constitution (see ‘Appendix IV’).

Even though the financial assessments of credit agencies are mostly claimed to be a matter of free speech and freedom of the press, their impact on investment decisions raises many doubts on the liability standard in case of faulty opinions. As already indicated, the US courts relied on the media position of CRAs by adopting the ‘actual malice’ standard for journalistic liability in case of inaccurate ratings.⁸³⁸ It can be claimed that the courts did not adequately evaluate the effects

⁸³⁶ Dieter Kerwer, ‘Holding Global Regulators Accountable. The Case of Credit Rating Agencies’, University of College London, School of Public Policy Working Paper Series No 11, December 2004, 15-16.

⁸³⁷ Gregory W. Smith, ‘The Deterioration of Investor Tools and the Resulting Fiduciary Challenges’ (2008) 57 *Journal of Government Financial Management*, 29.

⁸³⁸ *First Equity Corporation of Florida v Standard & Poor’s Corporation*, 690 F. Supp 256 (S.D.N.Y. 1988) (note 12); *In re Fitch Inc Fsbv UBS Paine Webber, Inc.*, 330 F.3d 104 (2d Cir. 2003). In these cases, the US courts recognized the journalist’s professional activity of CRAs by affirming that credit rating agencies could not be held liable for negligent misrepresentation (*Standard & Poor’s* case) and by granting the protection of the New York Press Shield Law (*In re Fitch* case). The Shield Law protects journalists from contempt for refusing to comply with a non-

of CRAs' assessments for the guidance of investors in their business transaction.⁸³⁹

If ratings are informed opinions about credit risk—resulting in detailed reports on the creditworthiness of financial products—it seems difficult to find any journalistic or media elements in this activity. The technical analysis, based on statistical models, contained in the rating methodologies cannot be compared to media information. Moreover, the traditional press would rarely have a close level of involvement with the source of its reporting of the sort that a CRA does.⁸⁴⁰

The main difference between a journalist and a credit rating agency lies in the nature of ratings. Journalists do not provide information to public for business purposes, whereas CRAs issue statements that influence investment decisions and play a powerful role in the financial markets. However, to be fair, the impact of some specialised media is very significant.

A journalist submits his work to an editor, but the subject of the piece is not automatically published if he or she is dissatisfied with the piece's content.⁸⁴¹ In the case of solicited ratings, CRAs work together with issuers to structure the transaction and receive high revenues for the services provided to clients. Because the rating agencies do not perform normal media functions it is paradoxical to consider that their evaluations are 'pure opinions'.⁸⁴²

Following these arguments, it can be argued that CRAs do not act as financial reporters because the service of issuing evaluations is not based on simple newsworthy information but is directed to specific clients or comes about because

party subpoena when the subpoena seeks to discover information conveyed to the journalist in confidence. It should be noted that in *Standard & Poor's* case, the court expressly recognized the newspaper publisher position of CRAs and stated that, in the absence of a contract, fiduciary relationship, or intent to cause injury, a newspaper publisher is not liable to a member of the public for a non-defamatory negligent misstatement of an item of news, "unless he wilfully ... circulates it knowing it to be false, and it is calculated to and does ... result in injury to another person".

⁸³⁹ *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 511 F. Supp. 2d 742, 816-17 (S.D. Tex. 2005).

⁸⁴⁰ Kenneth C. Kettering, 'Securitization and Its Discontents: The Dynamics of Financial Product Development' (2008) 29 *Cardozo Law Review* 4, 1690. See also *Commercial Financial Services, Inc. v Arthur Andersen LLP*, 94 P.3d 106, 110 (Okla. Civ. App. 2004). The US court held that the professional role of the rating agencies went 'beyond a relationship between a journalist and subject, and [was] more analogous to that of a client and the client's certified public accountant'. On this view, the court affirmed that the First Amendment does not shield the rating agencies from potential liability.

⁸⁴¹ Theresa Nagy (note 825) 159.

⁸⁴² Thomas J. Pate, 'Triple A rating stench: may the credit rating agencies be held accountable?' (2010) 14 *Barry Law Review* 1, 45, where the author observes that 'if credit rating agencies never issued unsolicited ratings, they would appear to be even less like financial publishers and therefore even less likely to be protected by free speech principles'.

they have been requested to act as a financial advisor by contractual parties. Succinctly put, ‘a credit rating is not published primarily for the purposes of reporting the news, but is instead issued for the purpose of effectuating financial transactions’.⁸⁴³

Market participants consider credit ratings to be a valuable benchmark for financial transactions on the account of their reputational capital derived from evaluating the solvency of firms. In this light, it is challenging to consider that ratings are mere opinions if they certify the quality of bonds and if that information is presented as a ‘stamp of approval’ for investors and so perceived as verifiable fact.⁸⁴⁴ It has been noted that ‘these assessments are not statements of mere opinion that deserve First Amendment protections, but are instead carefully reasoned representations made for the explicit purpose of industry reliance’.⁸⁴⁵ Although the ratings issued by the CRAs cannot be regarded as ‘mere opinions’, their principal function is signalling to the market participants about the credit risk of financial products. However, this signalling function has become a form of reliance for all users of ratings with the result to characterise these evaluations as ‘carrots in the mouth of donkeys’.

It is generally considered that the ‘AAA rating’ creates a form of safeguard, i.e. confidence, for investors by assuring them that they are investing only in the most secure financial product.⁸⁴⁶ For example, institutional investors (such as mutual funds, pension funds, municipal funds) or sophisticated investors (such as investment banks, alternative investments and sovereign wealth funds) recommend placing money in highly rated bonds. However, the ‘AAA rate’ often does not reflect the real risk of security used as a benchmark for retail investors in

⁸⁴³ A. Brooke Murphy, ‘Credit Rating Immunity? How the Hands-Off Approach Toward Credit Rating Agencies Led to the Subprime Credit Crisis and the Need for Greater Accountability’ (2010) 62 *Oklahoma Law Review* 4, 776.

⁸⁴⁴ Jonathan M. Barnett, ‘Certification Drag: The Opinion Puzzle and Other Transactional Curiosities’ (2007) 33 *The Journal of Corporation Law* 1, 139, where it is observed that ‘a credit rating can be viewed as a certification instrument that is provided by an issuer (through the third party rating agency) pursuant to the “constructive request” of the investor population (largely represented by agents in the form of money-managers and other investment fiduciaries)’.

⁸⁴⁵ Christopher Schmitt, ‘Holding the Enablers Responsible: Applying SEC Rule 10B-5 Liability to the Credit Rating Institutions’ (2011) 13 *University of Pennsylvania Journal of Business Law* 4, 1036.

⁸⁴⁶ A. Brooke Murphy (note 843) 742.

financial transactions (as, for example, in the case of the collapse of Enron and Lehman Brothers).⁸⁴⁷

Ratings are regarded as being a reliable source of information in the securities market and their flaws may have a catastrophic effect on the creditworthiness of firms. On this view, ratings do not warrant being categorised as ‘traditional speech’ or ‘commercial speech’ because CRAs not only provide an evaluation of the security but also are paid by issuers and are actively involved in the negotiations.⁸⁴⁸ A credit rating is not a mere matter of conveying information to the public, the recipient of that information sets out to make profits and most importantly, to alter financial operations. CRAs’ evaluations are associated with reliability, accuracy and in-depth analysis.

In this light, the ratings should not be viewed as simple statements but rather as certified information. As a result, the credit rating agencies should not be entitled to be protected under the US First Amendment shield and the US courts should not ignore the different positions of CRAs with respect to traditional financial journalists.

As discussed in the next section, CRAs’ statements should be subject to a specific liability standard, such as the tort of negligent misrepresentation in case of false information supplied to investors.⁸⁴⁹ However, inaccurate facts may be judged differently depending on whether CRAs knowingly report faulty ratings or act with intent or a reckless disregard for the truth.⁸⁵⁰ If the factual basis of ratings is found false owing to a series of errors, omissions and unjustifiable assumptions,

⁸⁴⁷ John C. Coffee Jr., ‘Understanding Enron: “It’s About the Gatekeepers, Stupid” (2002) 57 *The Business Lawyer* 4, 1405. See also Claire A. Hill, ‘Rating Agencies Behave Badly: The Case of Enron’ (2003) 35 *Connecticut Law Review* 3, 1145.

⁸⁴⁸ *Virginia State Board of Pharmacy v Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748, 96 S. Ct. 1817, 48 L. Ed. 2d 346, 1976 U.S. The court affirmed that commercial speech aims to propose a commercial transaction by providing information and advertisement of the characteristics of products.

⁸⁴⁹ Arthur R. Pinto, ‘Control and Responsibility of Credit Rating Agencies in the United States’ (2006) 54 *The American Journal of Comparative Law*, 353. The author pointed out that ‘the tort of negligent misrepresentation could be a possible basis of liability for users of the credit rating information. Plaintiffs must justifiably rely on the false information when the agency supplies it for the guidance of others in their business transaction and fails to exercise reasonable competence in obtaining or communicating the information’.

⁸⁵⁰ *Quinn v McGraw Hill Cos.*, 168 F.3d 331 (7th Cir. 1999) (note 856). The US court held that ‘S&P had no duty to communicate accurate information to investors and thus could not be liable for any negligence in the information furnished with the bonds at the time of purchase’. See also *Mallinckrodt Chemical Works v Goldman, Sachs Co.*, 420 F. Supp. 231, 244 (S.D.N.Y. 1976), where the court affirmed: ‘assuming that the rating was a statement of fact rather than an opinion, the prime rating was acceptable and if there was a misstatement of fact, it was an unwitting one’.

or if CRAs failed to properly conduct due diligence on underlying facts, the liability regime should apply.⁸⁵¹

Investors' reliance on ratings raises questions about the possible options where CRAs act recklessly. If rating agencies could be held accountable for improper credit ratings, this could determine positive effects, namely investor confidence and market stability. However, it also could have other consequences such as increased costs of corporate ratings, a decrease in the number of the companies willing to issue ratings, a higher barrier to entry for smaller rating agencies and probably, a change in CRAs' business model (from an 'issuer-pays' to a 'subscriber-pays' business model).⁸⁵²

After providing a critical appraisal of CRAs' categorisation as financial reporters, the next section takes into account the question of 'proximity' under the UK regime.

5.3 *The liability of CRAs under UK law: the question of 'proximity'*

Holding CRAs liable with respect to issuers and investors in case of defective ratings is the crucial dilemma for regulators and judicial claims. The role played by CRAs in the financial markets has caused commentators and policymakers to expend considerable energy in considering how the agencies might incur liability even in absence of any contractual relationship.

As has been noted by Manns, 'the challenges of rating agency accountability reflect an inherent conflict posed by interconnections of interest between ratings agencies and their commercial clients and the disconnect between rating agencies and beneficiaries of their screening roles'.⁸⁵³

⁸⁵¹ *Genesee County Employees' Retirement System v Thornburg Mortgage Securities Trust* 2006-3, 825 F. Supp. 2d 1082 (D.N.M. 2011). The court found that: (1) the credit ratings prominently displayed in the offering documents were false and misleading; (2) rating agencies used outdated and defective models when assigning their ratings; (3) rating agencies failed to conduct reasonable due diligence into the underwriters'/servicers' representations; and (4) rating agencies were not sufficiently independent when assigning their ratings. In addition, the judge held that the 'issuer-fee' model under which the rating agencies were employed resulted in conflicts of interest with issuers of securities. This undisclosed conflict arose because the rating agencies would only receive compensation if they provided the rating that the depositor, the underwriter, and the individual demanded.

⁸⁵² Kristofor W. Nelson, 'Rough Waters for the Ratings Companies: Should the Securities Ratings Companies Be Held Liable for Investor Reliance in the Wake of the Real Estate Meltdown of 2007-2008?' (2009) 63 *University of Miami Law Review* 4, 1204.

⁸⁵³ Jeffrey Manns, 'Rating risk after the subprime mortgage crisis: a user fee approach for rating

The challenging task is to hold CRAs accountable for their misconduct or inaccurate screening of credit risk and issuers' disclosure. During the 2007-2009 financial crisis, credit rating agencies failed to reduce the risk posed by the increasing complexity of securities in so far as they underestimated their systemic threat in the banking and corporate sector. Issuing ratings has become an activity in which CRAs act without control and without any constraints.

The regulatory reforms at US and EU level—discussed in Chapter three—established a rigid system of supervision designed to fill the accountability gap between credit rating agencies and investors. However, the reforms carried out by legislators leave space for CRAs to escape liability. In particular, the regulators have not solved the question of what kind of relationship exists with non-rating requesting issuers and what duties credit rating agencies should owe to investors.

The difficulties in dealing with the CRAs' accountability when third parties are involved in the business operations lie in the absence of contract. It is widely assumed that without a contractual relationship, i.e. the doctrine of privity in the common law of contract⁸⁵⁴, credit rating agencies generally do not owe any duties to investors who rely on ratings.

In the UK, the common law principle of 'privity' of contract may constitute a limitation to CRAs' liability because of the fundamental distinction between the positions of third parties that are not involved in a contractual relationship from the position of others that conclude an agreement with credit rating agencies.⁸⁵⁵

agency accountability' (2009) 87 *North Carolina Law Review* 4, 1015. The author suggests 'how debt purchasers may shoulder both the burdens and benefits of gatekeeper accountability by financing an SEC-administered user fee system as a quid pro quo for enforceable rights, yet shows how caps on liability and other safeguards would make gatekeepers' duties manageable'.

⁸⁵⁴ The 'privity of contract' doctrine means that a contract does not confer rights on someone who is not a party to the contract. Third parties are thus excluded from claiming performance or damages for non-performance. See on this discussion Hugh Beale, *Chitty on Contracts. General Principles* (note 769) Chapter one, para 1-194, where it is pointed out that 'at common law, in principle privity of contract prevents any breach by A of a term of a contract made with B from giving rise to any contractual liability in A to C, a third party to the contract'.

The doctrine of 'privity of contract' was raised in *Winterbottom v Wright* (1842) 10 M.W. 109, where the court held that a person who is not a party to the contract should not be considered capable of starting an action of tort. However, this approach was rejected by the House of Lords in *Donoghue v Stevenson* [1932] and subsequently contested within the doctrine of 'assumption of responsibility' that recognises the liability in negligence for pure economic loss. See *Junior Books Ltd v Veitchi Co Ltd* [1983] 1 A.C. 520.

⁸⁵⁵ Oliver von Schweinitz, *Rating Agencies: Their Business, Regulation and Liability Under U.S., U.K. and German Law* (Unlimited Publishing LLC Bloomington Indiana, 2007) 122-123.

The ‘privity’ of contract for the rating of the security is between the ratings companies and the companies that initially sell the securities.⁸⁵⁶

However, the use of ratings in investment decisions, and its impact on financial transactions raise many doubts about the lack of imposition of duties in respect of CRAs’ activities in cases of failure to exercise care or diligence.⁸⁵⁷

The focus on CRAs’ accountability takes into account their duties in assessing risks and overseeing issuer disclosures.⁸⁵⁸ It is possible to show that there is a causal nexus between the lax ratings process and gross damages sustained by the investing public (for example, in the bond insurers *MBIA, Inc.* and *Ambac Assurance Insurance, Inc.* failures).⁸⁵⁹

CRAs are intended to provide an accurate assessment of the risk of default so if that assessment is found misleading it should raise a degree of liability. By providing an outlook on financial products in order to help market participants make the right investment choices, the gatekeeping function is a matter of public interest and it should be accompanied by a correlative duty of providing reliable monitoring to protect investors.⁸⁶⁰

CRAs have access to privileged and confidential company information which they assess in order to perform their ratings. They provide qualified information that should reflect accurate, predictable and transparent knowledge about the creditworthiness of firms.⁸⁶¹ By issuing informed assessments CRAs provide ‘expertise’ in the financial market and investors place their confidence in the value of disclosures based on their reputational intermediary’s credibility.⁸⁶²

⁸⁵⁶ *Donoghue v Stevenson* [1932] AC 562 (note 747).

⁸⁵⁷ Arguably, in so far as certification and mandatory reporting duties are imposed on them, rating agencies have incentives to serve as more proactive watchdogs at a much earlier point in flagging the growing risks in order to save their own skins. This proposal includes capped liability exposure to creditors limited to cases of gross negligence, a system that should provide a framework for accountability, yet pose a manageable burden for rating agencies. See Jeffrey Manns (note 853) 1088-1089.

⁸⁵⁸ Jonathan R. Macey, ‘A Pox on Both of Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules’ (2003) 81 *Washington University Law Quarterly* 2, 342-343.

⁸⁵⁹ Aline van Duyn, ‘Ambac and MBIA suffer major losses’ *Financial Times* (London, 5 November 2008). See also Christine Richard, ‘Ambac’s Insurance Unit Cut to AA From AAA by Fitch Ratings’ *Bloomberg* (New York, 19 January 2008).

⁸⁶⁰ Peter B. Oh, ‘Gatekeeping’ (2004) 29 *The Journal of Corporation Law* 4, 741.

⁸⁶¹ Paul Robbe and Ronald Mahieu, ‘Are the Standards Too Poor? An Empirical Analysis of the Timeliness and Predictability of Credit Rating Changes’ (31 January 2005) <<http://ssrn.com/abstract=648561>> accessed 3 March 2014.

⁸⁶² David Reiss, ‘Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market’ (2006) 33 *Florida State University Law Review* 4, 1021.

It is generally accepted that confidence is the most important factor in the financial market; therefore if there is no proper monitoring system in place to ensure the CRAs' objectivity, this can potentially create a confidence crisis.⁸⁶³ It is arguable that whereas the issuer asks for a favourable rating, i.e. the highest possible rating, the investor is interested in a lower rating for a cheaper entry-level price in the financial market.⁸⁶⁴

CRAs represent a 'pendulum' in the market because of their powerful role to determine the volatility of assets. On the one hand CRAs have an interest in making profits by granting ratings, on the other hand there is an evident risk of disrupting the market and making issuers insolvent. In both scenarios, credit rating agencies do not incur any liability unless intentional misconduct in issuing inaccurate evaluations is proved, when tortious liability should apply.⁸⁶⁵ The question turns on investor over-reliance on fallible ratings: a possible solution would be to regulate the agencies in such a way that they are paid for by investors rather than issuers. In those circumstances, CRAs could not shelter behind the arguments of solicited ratings and disclaimed liability.

The accountability of CRAs should not be considered only a matter of investor's confidence or investor protection, but also a concern for the companies that request the ratings.

As already indicated, in the absence of contract it is difficult to hold rating agencies liable for faulty ratings and it is unrealistic to claim damages for a flawed rating in the absence of specific legislation addressing this matter. However, the same obstacles can be observed in a contractual relationship where the general rules of contract law apply in full. In particular, the underlying contracts often include a clause of exclusion of liability in favour of the agency that means any contractual claim may prove to be unsuccessful and likely to be dismissed.⁸⁶⁶

⁸⁶³ Emily Lee, 'Basel III: post-financial crisis international financial regulatory reform' (2013) 28 *Journal of International Banking Law and Regulation* 11, 441.

⁸⁶⁴ Imad Moosa, 'Shelter from the Subprime Financial Crisis' (2008) 4 *Monash Business Review* 1, 31-33.

⁸⁶⁵ Victor P. Goldberg, 'Accountable Accountants: Is Third-Party Liability Necessary?' (1988) 17 *The Journal of Legal Studies* 2, 311-312. The author discussed the scope of tort liability to cover third parties not in 'privity' with producers of goods or services and argued that 'where contracts can effectively assign responsibility for losses and where it is unlikely that most victims would be willing to pay for protection, it would be unwise to rely on tort law' (at 311).

⁸⁶⁶ Brigitte Haar, 'Civil Liability of Credit Rating Agencies after CRA 3 – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence', University of Oslo Faculty of Law Legal Studies Research Paper Series No 2013-02, 3.

The contractual imbalance between CRAs and issuers could reinforce the virtually complete immunity of credit agencies, and underlines the need to find a means of holding them liable. If investors may claim directly against the rating agency for losses suffered during a financial transaction the insolvency risk would be shifted to the CRA, which could have more of an incentive to avoid losses as result of flawed assessments. This would allow investors to sue CRAs without any contractual relationship, a scenario that could change the credit rating agencies' *modus operandi* and give more chances to investors to sue where necessary.

In the UK, section 90A and Schedule 10A of the Financial Services and Markets Act 2000 (Liability of Issuers) Regulations 2010 make issuers of securities liable in connection with published information 'to persons who have suffered loss as a result of (1) a misleading statement or dishonest omission in certain published information relating to the securities; or (2) a dishonest delay in publishing such information'.

The UK legislation may be examined in conjunction with the US legislation since the US introduced a private cause of action under which investors can sue credit rating agencies for knowingly or recklessly failing to conduct a reasonable investigation of facts (or for failing to obtain an analysis from an independent source). In particular, Rule 436(g) of the Securities Act of 1933—repealed by the Dodd-Frank Act⁸⁶⁷—made rating agencies subject to 'expert liability' for misleading statements in registration statements under Section 11 of the 1933 Securities Act.⁸⁶⁸

It has been observed that 'the repeal of Rule 436(g) has created a dilemma in the sense that it results in either party's liability, depending on whether the ratings are included or not, without actually clarifying the crucial issues of the liability

⁸⁶⁷ Baker & McKenzie, 'The Repeal of Rule 436(g): Effects on the Asset-Backed Securities Market', Legal Alert, July 2010.

⁸⁶⁸ Section 11 of the 1933 Securities Act ('Civil Liabilities on Account of False Registration Statement'), under which experts are subject to enhanced liability for untrue and misleading statements included in the registration statement. See Lisbeth Freeman (note 798) 612-613 where it is noted that CRAs could be held liable through the 'Control Person liability' under Section 20(a) of the 1934 Exchange Act. Section 20(a) provides that 'every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action'.

problem'.⁸⁶⁹ On this view, the US legislator has added a layer of uncertainty by introducing a safe harbour for credit rating agencies that can easily avoid liability when issuers do not include ratings in their registration statement or when CRAs refuse to have their ratings included in registration statements.⁸⁷⁰

Recently, there have been court decisions in the US recognizing the accountability of credit rating agencies for negligent misrepresentation in financial transactions.⁸⁷¹ Generally, investors argue that rating agencies negligently issued inaccurate ratings, thereby breaching a duty of care owed to investors to give accurate information.

Negligent misrepresentation claims should be based on the following elements: (1) a misstatement or omission of a material fact, made *scienter*⁸⁷²; (2) a reasonable investor, i.e. informed person, who conscientiously relied on the CRA's rating; and (3) the proximity between CRAs and investors who suffered damages from inaccurate ratings.⁸⁷³ Proximity should establish whether or not positive relationships exist between the parties in terms of causal pathways by which the defendant's failure might have caused injury to the claimant.⁸⁷⁴

⁸⁶⁹ Brigitte Haar (note 866) 9.

⁸⁷⁰ Benjamin H. Brownlow (note 814) 112-113.

⁸⁷¹ *California Public Employees' Retirement Systems (CalPERS) v Moody's Corp.*, No. CGC-09-490241 (Cal. App. Dep't Super. Ct. July 9, 2009). The judge held that the pension fund produced sufficient evidence that the credit rating agencies had acted fraudulently by making misrepresentations without reasonable grounds to believe that they were telling the truth. The US court found that Moody's, S&P's, and Fitch assigned untrue, inaccurate, and unjustifiably high credit ratings to the senior debt of the Structured Investment Vehicles (SIVs). These credit ratings were false at the time they were initially assigned, and continued to be false during the existence of the SIVs. The court observed that rating agencies knew at all times that their SIV ratings would be relied upon by the same qualified institutional buyers and qualified purchasers to which the SIVs were marketed. Most importantly, the US courts affirmed that there was a close connection between the rating agencies' negligent rating actions and the plaintiff's injury. This case showed that CRAs may be liable for fraud: however, in this circumstance the plaintiff is required only adduce facts from which it may be inferred that the CRA knowingly or recklessly failed to conduct reasonable due diligence to verify factual information used in a credit rating.

⁸⁷² The term *scienter* is generally referred to intent or knowledge of wrongdoing of an act committed by the offending party. See William H. Kuehnle, 'On Scierter, Knowledge, and Recklessness under the Federal Securities Laws' (1997) 34 *Houston Law Review* 1, 159-161.

⁸⁷³ Timothy M. Sullivan, 'Federal Preemption and the Rating Agencies: Eliminating State Law Liability to Promote Quality Ratings' (2010) 94 *Minnesota Law Review* 6, 2148.

⁸⁷⁴ Christian Witting, 'Duty of Care: An Analytical Approach' (2005) 25 *Oxford Journal of Legal Studies* 1, 40-41. The author observes that 'proximity criteria are unequivocal as indicators of the presence or absence of a substantial ability on the part of the defendant to cause injury to the claimant. The presence of proximity factors points in the direction of a duty being recognized, while the absence of such points away from the recognition of a duty'. See also Christian Witting, *Liability for negligent misstatements* (Oxford: OUP 2004) 26 and 28. On the judicial exposition of the function of proximity see *Sutherland Shire Council v Heyman* (1985) 15 CLR 424, HCA at 497-498; *Jaensch v Coffey* (1984) 155 CLR 549, HCA at 578-586.

In *New Jersey Carpenters Vacation Fund v Harbor View Mortgage Loan Trust*, the plaintiffs alleged that the rating agencies knowingly issued overly high ratings for mortgage-backed products in violation of federal securities law.⁸⁷⁵

The element of ‘proximity’ should be solved by the assertion that misrepresented material facts disclosed within ratings are designed to be used by reasonable investors in the financial markets. In this way, the rating (1) does not provide securities information to investors in a cost-effective manner; (2) does not reduce transaction costs; and (3) does not reduce information asymmetries between market participants.

In this light, investors cannot claim damages suffered where CRAs’ evaluations were the motivating factor in the investment decision. Under this approach, any liability seems to be limited to relations between CRAs and issuers only, because investors have no chance of being compensated for financial losses caused by inaccurate ratings. However, CRAs should owe the highest level of diligence, prudence and loyalty in issuing their evaluations not only for the sake of market integrity, but also for maintaining confidence among market participants.⁸⁷⁶

Consequently, the expectations of investors—as receivers of CRAs’ evaluations—should be aligned with those of rated firms by giving them the possibility to bring a civil suit against CRAs for losses arising from detrimental reliance on their ratings.⁸⁷⁷ In this regard, it has been observed that ‘rating agencies should be held liable where the factual basis of their ratings is false or where they have failed properly to analyse underlying facts. Where the agency got the facts right, but simply drew the wrong conclusion, liability should not apply’.

The contractual relationship raises a direct liability of CRAs to issuers while in the absence of contract an indirect liability or non-contractual liability of CRAs to investors should apply in case of negligent ratings.

⁸⁷⁵ *New Jersey Carpenters Vacation Fund v Harbor View Mortgage Loan Trust*, 581 F. Supp. 2d 581 (S.D.N.Y. 2008) (No. 08 Civ. 5093). The investors argued that they relied on these alleged material misstatements in their decision to purchase *Harbor View’s* mortgage-backed products and suffered damage when the mortgage-backed investment market collapsed and those securities dropped precipitously in value.

⁸⁷⁶ Graeme Baber, ‘The role and responsibility of credit rating agencies in promoting soundness and integrity’ (2014) 17 *Journal of Money Laundering Control* 1, 35.

⁸⁷⁷ Matthias Lehmann, ‘Civil Liability of Rating Agencies: An Insipid Sprout from Brussels’, LSE Law, Society and Economy Working Papers 15/2014, 8.

After considering the question of ‘proximity’ in finding a degree of liability for CRAs, the next section focuses on CRAs’ civil liability regime under EU law by looking at some of the strategies regulators should adopt to manage their legitimacy.

5.4 The civil liability regime for CRAs under the EU regulatory framework

Regulation (EU) No 462/2013⁸⁷⁸ introduced a civil liability regime for CRAs at the European level. This change of the EU legislator towards supplementing the regime of regulatory sanctions for CRAs by civil liability rules might be considered to have long been due.⁸⁷⁹

However, the efficiency and effectiveness of the EU provisions depend widely on their design in detail and the potential to facilitate their enforcement.⁸⁸⁰ The structure and wording of the civil liability rules for CRAs under the 2013 CRA Regulation raise multiple questions.

Article 35a(1) of the Regulation establishes a statutory cause of action against rating agencies. The provision states:

“Where a credit rating agency has committed, intentionally or with gross negligence, any of the infringements listed in Annex III having an impact on a credit rating, an investor or issuer may claim damages from that credit rating agency for damage caused to it due to that infringement. An investor may claim damages under this Article where it establishes that it has reasonably relied in accordance with Article 5a(1) or otherwise with due care, on a credit rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating. An issuer may claim damages under this Article where it establishes that it or its financial instruments are covered by that credit rating and

⁸⁷⁸ Regulation (EU) No 462/2013. Regulation No 462/2013 was accompanied by Directive 2013/14/EU of the European Parliament and of the Council of 21 May 2013 amending Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers in respect of over-reliance on credit ratings (OJ 2013 L 145 p. 1).

⁸⁷⁹ Gudula Deipenbrock, ‘Civil liability of credit rating agencies in the European Union – selected international private law issues’, Seminar organised by the University of London, Institute of Advanced Legal Studies, 30 January 2014.

⁸⁸⁰ Mads Andenas, ‘Selected aspects of civil liability of CRAs in the European Union (EU) – Art. 35a of the (draft) Second CRA Amending Regulation. The problem of burden of proof’, Seminar on the Civil Liability of Credit Rating Agencies in the European Union, Oslo, 3 June 2013.

the infringement was not caused by misleading and inaccurate information provided by the issuer to the credit rating agency, directly or through information publicly available”.⁸⁸¹

The rule introduces the possibility for investors or issuers to claim damages where credit rating agencies have deliberately infringed, or acted with gross negligence in breach of, any obligations imposed on them by Regulation (EC) No 1060/2009⁸⁸², and the infringement had an ‘impact’ on the rating outcome.⁸⁸³

Recital 33 in the preamble to the 2013 CRA Regulation qualifies this somewhat: (1) ‘because the activity of credit rating involves a certain degree of assessment of complex economic factors’; and (2) ‘the application of different methodologies may lead to different rating results, none of which can be considered as incorrect’.⁸⁸⁴

The important aspect is that the infringements listed in Annex III of the 2013 CRA Regulation serve as a foundation for a liability claim.⁸⁸⁵ The condition for liability is the existence of damage caused by the infringement.

In detail, an investor who does not have a contractual relationship with the CRA may claim damages where he/she demonstrates that he/she placed reasonable reliance or reliance with due care in a credit rating when entering into an investment decision. The investor must have consciously relied (and not mechanistically over-relied) or paid due attention to a credit rating before making a decision. The investor has to establish reasonable reliance in accordance with Article 5a(1), which aims at mitigating over-reliance on credit ratings by financial institutions.

⁸⁸¹ Article 35a(1) of Regulation (EU) No 462/2013 (amending Regulation (EC) No 1060/2009 on credit rating agencies).

⁸⁸² Recital 33 in the preamble to Regulation (EU) No 462/2013, where it is stated that ‘it is appropriate to expose credit rating agencies to potentially unlimited liability only where they breach Regulation (EC) No 1060/2009 intentionally or with gross negligence’.

⁸⁸³ Recital 32 in the preamble to Regulation (EU) No 462/2013.

⁸⁸⁴ Recital 33 in the preamble to Regulation (EU) No 462/2013.

⁸⁸⁵ Annex III to Regulation (EU) No 462/2013 provides a catalogue of infringements upon which claimants may rely: some of these concern several duties including requirements concerning the CRA’s organization, operation and independence. For instance, infringements by CRAs that may form the basis of a claim are: (1) not ensuring rating analysts have appropriate knowledge and experience for the duties assigned (para. 1(27) of Annex III); or (2) not adopting adequate measures to ensure that credit ratings are based on a thorough analysis of all the information that is available (para 1(42) of Annex III).

An issuer may claim damages where he/she demonstrates that the infringement was caused by a misleading or an inaccurate rating from a CRA that it is not based on the issuer's information.

From an examination of Article 35a(2) of the 2013 CRA Regulation, it appears that the burden of proof is borne by the investor (or issuer) in so far as he has 'to present accurate and detailed information indicating that the credit rating agency has committed an infringement of this Regulation, and that infringement had an impact on the credit rating issued'.⁸⁸⁶ The assessment of what constitutes 'accurate and detailed information' is delegated to competent national courts 'taking into consideration that the investor or issuer may not have access to information which is purely within the sphere of the credit rating agency' (Article 35(2) subparagraph 2).

It should be noted that the regime introduced by Article 35a(2) differs significantly from the Commission's proposal which was more favourable to investors because any exclusion or limitation of civil liability stipulated in advance by agreement would have been null and void under the original proposal.⁸⁸⁷

A reasonable question is raised by the regulatory perspective of the burden of proof, namely the cross-border investigations and enforcement: it may be difficult to ensure the same level of supervision owing to the different approaches taken in different jurisdictions. By the same token, it may be difficult for investors to carry out sufficient scrutiny (and engage in regular due diligence) over CRAs' *modus operandi* in order to show that the ratings were potentially inaccurate or in the nature of misrepresentations.⁸⁸⁸

⁸⁸⁶ Article 35a(2) of Regulation (EU) No 462/2013 (amending Regulation (EC) No 1060/2009 on credit rating agencies).

⁸⁸⁷ European Commission, 'Proposal for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies' COM (2011) 747 final, 15 November 2011, 33. The Commission's proposal proposed the following rule: 'where an investor establishes facts from which it may be inferred that a credit rating agency has committed any of the infringements listed in Annex III, it will be for the credit rating agency to prove that it has not committed that infringement or that infringement did not have an impact on the issued credit rating'. The Proposal provided that 'the civil liability referred to in paragraph 1 shall not be excluded or limited in advance by agreement. Any clause in such agreements excluding or limiting the civil liability in advance shall be deemed null and void'.

⁸⁸⁸ Gudula Deipenbrock, 'Trying or Failing Better Next Time? – The European Legal Framework for Credit Rating Agencies after Its Second Reform' (2014) 25 *European Business Law Review* 2, 221.

The interesting part of this regulatory approach can be found in Article 35a(3) where it is stated that ‘the civil liability of credit rating agencies, as referred to in paragraph 1, shall only be limited in advance where that limitation is: (a) reasonable and proportionate; and (b) allowed by the applicable national law in accordance with paragraph 4’.⁸⁸⁹

The EU legislator introduces specific conditions to limit the civil liability regime of CRAs: conditions that allow national laws to define the boundaries of liability. This rule could open the doors for different legal treatment by national courts. The risk that too much may have been left to national laws when it comes to the application of civil liability for CRAs becomes even more apparent in the light of the wording of Article 35a(4):

“Terms such as ‘damage’, ‘intention’, ‘gross negligence’, ‘reasonably relied’, ‘due care’, ‘impact’, ‘reasonable’ and ‘proportionate’ which are referred to in this Article but are not defined, shall be interpreted and applied in accordance with the applicable national law as determined by the relevant rules of private international law. Matters concerning the civil liability of a credit rating agency which are not covered by this Regulation shall be governed by the applicable national law as determined by the relevant rules of private international law. The court that is competent to decide on a claim for civil liability brought by an investor or issuer shall be determined by the relevant rules of private international law”.⁸⁹⁰

At the UK level, Article 35(a) of Regulation (EU) No 462/2013 has been implemented by the Credit Rating Agencies (Civil Liability) Regulations 2013 (the Regulations).⁸⁹¹

These Regulations require that the infringement must be placed intentionally or with gross negligence if the senior management of the CRA: (1) acted deliberately to commit the infringement⁸⁹²; and (2) were reckless as to whether the infringement occurred.⁸⁹³ In addition, an infringement has an impact on a credit rating if it results in a different rating category being assigned to the issuer or the

⁸⁸⁹ Article 35a(3) of Regulation (EU) No 462/2013 (amending Regulation (EC) No 1060/2009 on credit rating agencies).

⁸⁹⁰ Article 35a(4) of Regulation (EU) No 462/2013 (amending Regulation (EC) No 1060/2009 on credit rating agencies).

⁸⁹¹ Credit Rating Agencies (Civil Liability) Regulations 2013 (SI 2013/1637).

⁸⁹² Section 3 of Regulations.

⁸⁹³ Section 4 of Regulations. The definition of ‘gross negligence’ is restricted by Section 4(2) of the Regulations that states ‘the senior management of a credit rating agency are reckless if they act without caring whether an infringement occurs’.

financial instrument of the issuer to which the credit rating relates and that the infringement caused them to suffer damage.⁸⁹⁴

For the purposes of Article 35a(4), the UK law: (1) ascribed to ‘gross negligence’ the meaning of recklessness; (2) included indicative factors in the instrument to assist the court in considering whether limitations CRAs have sought to place on their liability are ‘reasonable and proportionate’⁸⁹⁵; and (3) defined ‘damage’ in line with national law for the equivalent area, namely tort and contract (in the case where a rating has been ascribed on a solicited basis, under a contract).⁸⁹⁶

Regarding the terms ‘reasonably relied’, ‘due care’ and ‘caused’, the Credit Rating Agencies (Civil Liability) Regulations 2013 provides the following definitions: (1) the test for whether the reliance is reasonable is the same as for whether it is reasonable for a person to rely on a statement for the purposes of determining whether the statement gives rise to a duty of care in negligence⁸⁹⁷; (2) if the investor took the care a reasonably prudent investor would have exercised in the circumstances⁸⁹⁸; and (3) the test of causation in negligence applies for the purposes of determining whether an infringement caused damage.⁸⁹⁹

It should be noted that the English courts tend to favour the principle of ‘caveat emptor’ that means investors have to be responsible for their investment decisions.⁹⁰⁰ In this way, investors are discouraged from passively relying on ratings. However, the extent to which the ‘due care’ test requires private investors to conduct their own credit risk assessment, and the nature of those risk assessments is far from clear.⁹⁰¹

⁸⁹⁴ Section 5 of Regulations. Causation will be established by applying the ‘but for’ test. Claimants will need to show that but for the CRA’s relevant infringement they would have been better off. For an academic commentary, see Andrew Wanambwa, ‘Civil liability of credit rating agencies’ (2014) 29 *Journal of International Banking Law and Regulation* 8, 520.

⁸⁹⁵ Regulation 9b of Credit Rating Agencies (Civil Liability) Regulations 2013, where it is stated that limitation on liability is reasonable and proportionate ‘having regard to the factors provided in regulations 10, 11 and 12 as the court considers relevant’.

⁸⁹⁶ Explanatory Memorandum to the Credit Rating Agencies (Civil Liability) Regulations 2013 (2013 No 1637) para 7.5.

⁸⁹⁷ Section 6(2) of the Credit Rating Agencies (Civil Liability) Regulations 2013.

⁸⁹⁸ Section 7 of the Credit Rating Agencies (Civil Liability) Regulations 2013.

⁸⁹⁹ Section 8 of the Credit Rating Agencies (Civil Liability) Regulations 2013.

⁹⁰⁰ Harry Edwards, ‘CRA 3 and the liability of rating agencies: inconsistent messages from the regulation on credit rating agencies in Europe’ (2013) 7 *Law and Financial Markets Review* 4, 189.

⁹⁰¹ Andrew Wanambwa (note 894) 521.

Regarding the approach to determining damages, Section 14 of the Regulations provides that ‘the damages recoverable by an investor under Article 35a are: (1) contractual damages, where the investor enters into a contract with a CRA to provide a credit rating; or (2) where in absence of a contractual relationship, the damages that would be recoverable by the investor if the investor had succeeded in a claim against the credit rating agency in the tort of negligence’. In this regard, UK courts are generally reluctant to consider tort remedies such as tort of negligence in the absence of the following elements: (1) a duty of care; (2) a breach of that duty; and (3) consequential damages. The duty of care implies the existence of some type of relationship between the claimant and the defendant prior to the infliction of harm. Further, the UK courts are reluctant to consider liability for negligent misrepresentation in the absence of ‘proximity’ and to award compensation for pure economic losses in absence of a duty of care.⁹⁰²

At the EU level, the contractual relationship between credit rating agencies and issuers is governed by contract law as provided by domestic rules. There is no single legislation governing obligations between parties, and contractual claims against CRAs are treated differently among Member States.

The absence of a unique, harmonized regime for regulating contracts with credit rating agencies makes the civil liability regime a matter for national courts.⁹⁰³ This problem could give rise to serious difficulties in the area of conflict of laws and to regulatory arbitrage between States.⁹⁰⁴ For instance, in case of pecuniary loss it could be difficult to find the location of assets affected by inaccurate ratings. Further, it might be difficult to identify the location of occurred damages, and in particular: (1) the country where the issuer requested to be rated;

⁹⁰² *Spartan Steel and Alloys Ltd v Martin & Co (Contractors) Ltd* [1973] QB 27, where Lord Davies pointed that ‘where a defendant who owes a duty of care to a plaintiff breaches that duty and, as both a direct and a reasonably foreseeable result of that injury, the plaintiff suffers only economic loss, he is entitled to recover that loss as damages and, since the plaintiffs’ financial loss was both the direct and foreseeable consequence of the defendants’ negligence, they were rightly awarded damages for their financial loss’.

⁹⁰³ Brigitte Haar, ‘Civil Liability of Credit Rating Agencies after CRA 3 – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence’ (2014) 25 *European Business Law Review* 2, 316. The author argues that the civil liability regime as introduced by the 2013 EU Regulation is the result of political controversies among EU Institutions and it does not seem convincing for its typical spirit of compromise.

⁹⁰⁴ Alessandro Scarso, ‘The Liability of Credit Rating Agencies in a Comparative Perspective’ (2013) 4 *Journal of European Tort Law* 2, 163.

(2) the country in which the investor is damaged; or (3) the country in which the CRA issues the ratings.

In this scenario private international law questions arise. In case of solicited ratings—in presence of contractual obligations—the law applicable is determined by Article 3(1) of Regulation (EC) No 593/2008 ‘on the law applicable to contractual obligations’ (Rome I).⁹⁰⁵ In case of unsolicited ratings, the choice of law is regulated by Article 4(1) of Regulation (EC) No 864/2007 ‘on the law applicable to non-contractual obligations’ (Rome II).⁹⁰⁶ This rule provides that the governing law is “the law of the country in which the damage occurs”: the application of this rule may imply different interpretations because of the absence of a special rule for financial torts in the Rome II Regulation.⁹⁰⁷

Article 35a(5) of Regulation (EU) No 462/2013 provides that ‘this provision does not exclude further civil liability claims in accordance with national law’.⁹⁰⁸ Having regard to the UK Regulations, the question at stake is whether they leave room for the application of other tortious remedies or estoppel.

CRAs were already subject to civil liability in the United Kingdom under domestic common law: pre-existing forms of civil liability in UK common law are

⁹⁰⁵ Article 3(1) of Regulation (EC) No 593/2008 ‘on the law applicable to contractual obligations’ (Rome I) (OJ 2008 L 177 p. 6) that states ‘a contract shall be governed by the law chosen by the parties. The choice shall be made expressly or clearly demonstrated by the terms of the contract or the circumstances of the case. By their choice the parties can select the law applicable to the whole or to part only of the contract’.

⁹⁰⁶ Article 4(1) of Regulation (EC) No 864/2007 ‘on the law applicable to non-contractual obligations’ (Rome II) (OJ 2007 L 199 p. 140) that states ‘the law applicable to a non-contractual obligation arising out of a tort/delict shall be the law of the country in which the damage occurs irrespective of the country in which the event giving rise to the damage occurred and irrespective of the country or countries in which the indirect consequences of that event occur’. The Regulation is of universal application: the law specified is applied whether or not it is the law of a Member State.

For learned commentaries see Giesela Ruehl, ‘German Federal Supreme Court Rules on Jurisdiction over US Credit Rating Agency’, 22 January 2013 <<http://www.conflictoflaws.net>> accessed 24 April 2014. The author commented a decision of 13 December 2012 in which the German Federal Supreme Court had to deal with the question of whether (and under what conditions) German courts have jurisdiction to hear claims of German investors against American based US credit rating agencies for losses suffered in the aftermath of the 2008 financial crisis. This ruling clearly shows the issue of conflict of laws in the CRAs’ civil liability regime, a question that could be problematic if the EU legislator does not intervene to define the procedural aspects of liability claims. See also Anatol Dutta, ‘The liability of American credit rating agencies in Europe’ (2014) 1 *Praxis des Internationalen Privat- und Verfahrensrechts*, 33. It is observed that ‘it is not necessarily the case that a European liability regime – be it at the Member State level or at the European Union level such as the recently introduced Article 35a of the European Regulation on Credit Rating Agencies – will adequately encompass the American agencies and their ratings’.

⁹⁰⁷ Matthias Lehmann (note 877) 24.

⁹⁰⁸ Article 35a(5) of Regulation (EU) No 462/2013 (amending Regulation (EC) No 1060/2009 on credit rating agencies).

the tort of negligent misstatement and, in cases where the rating is provided by agreement, under contract law.⁹⁰⁹

As indicated, negligent misstatement can be defined as a false statement of fact which is made honestly but carelessly. In this case, CRAs could be held liable if there has been breach of a duty to take care in making the statements that have caused damage to the claimant, who reasonably relied on them. Under such circumstances, equitable estoppel may be applied to rating agencies' evaluations as a rule of evidence in terms of establishing a fact necessary to complete a cause of action—for instance, to overcome the question of 'proximity'. In this light, it seems that the UK Regulations leave room for the application of estoppel as a complement to tort liability.

As indicated, under Article 35a the investor has to show that it reasonably relied on the credit rating for an investment decision and to present accurate and detailed information indicating that the CRA committed an infringement of the regulation, and that infringement had an impact on the credit rating issued. However, estoppel may usefully be brought into play as a rule of evidence.

First, it would seem under Article 35a(2), second subparagraph, that the CRA is estopped from relying, as against the investor's evidential burden to present accurate and detailed information, on information which is purely within the sphere of the CRA. Secondly, it can be argued that estoppel may be used by the investor as a viable argument to defeat a plea by the CRA that there is no contractual relationship between it and the investor. Lastly, the courts could hold that the CRA is estopped from denying the correlation, and eventually the cause of damages, between the time of issuing the rating and time of making the investment decision. The fact that Regulation (EU) No 462/2013 on CRAs requires Member States to make provision in their national law for third parties to sue when they relied on a credit rating by a CRA allows it to be argued that the UK and other common law States could base their remedy on estoppel. However, it may be questioned whether CRAs would be still willing to rate in a more hostile environment (of increased liability).

⁹⁰⁹ Explanatory Memorandum to the Credit Rating Agencies (Civil Liability) Regulations 2013 (2013 No 1637) para 7.4. See also House of Lords European Union Committees, Economic and Financial Affairs and International Trade (Sub-Committee A), Credit Rating Agencies (17308/11, 17329/11), Letter from the Chairman to Mark Hoban MP, Financial Secretary, HM Treasury, 13 where it was affirmed that '[CRAs] should be held responsible for negligence or misconduct when producing those ratings'.

At this point, it is possible to draw some conclusions. In the final analysis, Article 35a of Regulation No 462/2013 would seem to boil down to a reference to national law as determined by the rules of private international law in so far as it provides for the definition of a tort⁹¹⁰ but leaves all the relevant ingredients ('damage', 'intention', 'gross negligence', 'reasonably relied', 'due care', 'impact', 'reasonable' and 'proportionate') to the applicable national law as determined by the relevant rules of private international law.

Moreover, limitation clauses are only allowed where they are reasonable and proportionate and allowed by the applicable national law. Consequently, whether a CRA is to be held liable depends virtually entirely on national law. There is no uniform accountability regime under EU law and what kind of liability to attach to CRAs remains somewhat obscure. Indeed, it is possible that the European courts will have to apply US law to the CRAs, since the 'relevant rules of private international law' are those of the Rome II Regulation, Article 3 of which provides that 'any law specified by this Regulation shall be applied whether or not it is the law of a Member State'.

The 2013 CRA Regulation restores credibility surrounding credit ratings by enhancing a rules-based approach (and by improving behavioural changes on the part of investors) however its success will be tested in actual civil enforcement actions against CRAs. It has been noted that 'the institution of a right for investors to sue credit rating agencies may be regarded as a major step that overcomes a key impediment to market discipline and fosters a deeper cultural change in the credit rating sector as direct accountability is now owed to investors'.⁹¹¹

The 2013 CRA Regulation attempts to introduce high standards of liability for CRAs by establishing a tort law regime although a harmonized European tort law system does not exist and there are no plans to introduce such a regime among EU Member States.⁹¹²

⁹¹⁰ Namely that where a credit rating agency has committed, intentionally or with gross negligence, certain infringements having an impact on a credit rating, an investor or issuer may claim damages from that credit rating agency for damage caused to it due to that infringement where it has reasonably relied on a credit rating for a decision to invest in, hold onto or divest its off of a financial instrument covered by that credit rating.

⁹¹¹ Iris H-Y Chiu, 'Regulating Credit Rating Agencies in the EU: In Search of a Coherent Regulatory Regime' (2014) 25 *European Business Law Review* 2, 279.

⁹¹² Wouter den Hollander, 'European tort law through the front door: civil liability of credit rating agencies', Leiden Law Blog, 8 July 2013.

On the one hand, the EU reform seeks to rebuild financial confidence by holding CRAs liable for their inaccurate ratings, on the other, it completely leaves to national laws the role of applying and interpreting the rules.⁹¹³ It would be helpful for the courts to understand not only the link between CRAs and investors, but also the appropriate amount of liability for credit rating agencies.⁹¹⁴

In the light of the above considerations, despite its shortcomings, EU civil liability for CRAs may be considered an important step forward in the regulation of credit ratings industry.⁹¹⁵ However, the EU legislator missed an opportunity to secure a harmonized regime of civil liability among Member States. As Lehmann has pointed out, ‘by calling upon each Member State to adopt its own version of the cause of action, the Regulation sets the divergences between national laws in stone’.⁹¹⁶

After providing an analysis of the EU civil liability regime for credit rating agencies introduced by the 2013 CRA Regulation, the ensuing sections examine the developments in the case law taking into account the position of Australian courts for CRAs’ liability.

5.5 Developments in case law: the Australian decision in Bathurst Regional Council v Local Government Financial Services Pty Ltd

Criticisms of the CRAs’ activities have been generally accompanied by scant attention to the credit rating agencies’ accountability. However, the development of the case law showed changes in the judgments of the Australian courts, which were more prone to recognize rating agencies’ liability for investor losses.

The relevance of analysing the approach taken by Australian judges to liability on the part of CRAs lies in the recent landmark decisions that marked unprecedented legal actions against one of the leading credit rating agencies (S&P’s) after the 2007-2009 financial crisis and 2010-2012 sovereign debt

⁹¹³ Aron Verstandig, ‘Civil Liability for Credit Ratings Agencies: A Swedish Perspective’ (2014) 25 *European Business Law Review* 2, 346.

⁹¹⁴ Cheryl Evans, ‘What Makes You So Special?: Ending the Credit Rating Agencies’ Special Status and Access to Confidential Information’ (2012) 46 *Valparaiso University Law Review* 4, 1111.

⁹¹⁵ Niamh Moloney, ‘Resetting the location of regulatory and supervisory control over EU financial markets: lessons from five years on’ (2013) 62 *International and Comparative Law Quarterly* 4, 963.

⁹¹⁶ Matthias Lehmann (note 877) 20.

crisis.⁹¹⁷ Further, analysis of the arguments followed by the courts in the relevant judgments raises the question of the favourable approach for investor protection adopted in the Australian legislation.⁹¹⁸

The Australian courts commenced by reducing freedom-of-speech protection and freedom of the press in circumstances where the rating is based on incorrect facts by holding CRAs liable for negligent misrepresentations relating to the creditworthiness of structured financial products.⁹¹⁹ In this context, a leading case is the first-instance judgment in *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* ('*Bathurst*'), where the Federal Court of Australia held that the rating agency owed a duty of care to investors as regards complex structured credit products.⁹²⁰

The court found that S&P's and ABN Amro were liable for negligent misrepresentation (and breach of the Australian consumer protection prohibition on misleading or deceptive conduct) to a group of local Councils.⁹²¹ It is ruled that S&P's deceived and misled local councils in awarding a triple 'A' rating to a complex derivative product issued by ABN Amro. The difficulty with this case is that the particular financial product (the subject of these proceedings) was customized by S&P's using the bank's own model, and there were a number of

⁹¹⁷ Rommel Harding-Farrenberg and Kieran Donovan, 'Duty of Care, Rating Agencies and the 'Grotesquely Complicated' Rembrandt: Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) (2013) 14 *Business Law International* 2, 185.

⁹¹⁸ As a matter of clarity, the Australian system of corporate law is characterized by a centralized federal power with national regulators. This federal law system emerges, for example, in The Corporations Act 2001 (Cth), 'a result of a constitutional referral by each State of its corporate law powers to the Australian Commonwealth government'. See Jennifer G. Hill, 'Why did Australia fare so well in the global financial crisis?' in Eilís Ferran, Niamh Moloney, Jennifer G. Hill, John C. Coffee, Jr (eds), *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge: CUP 2012) 216.

⁹¹⁹ See the considerations carried out in the research seminar "The Legal Framework of claims against Rating Agencies" hosted by the University of Sydney, 27 March 2013, where Prof. McDonald discussed the new frontiers of liability for CRAs in the recent Australian cases *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liquidation)* [2012] FCA 1028 and *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200.

⁹²⁰ *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200. The Court found the rating agency liable for their inaccurate ratings. This case marks the first significant victory in a claim against a credit rating agency. The main points affirmed by the Federal Court of Australia are: (1) a rating agency may have a duty of care to investors even in the absence of a contractual relationship; (2) the duty of care is established to ensure that a rating is issued with reasonable basis; (3) where a rating agency issues a rating without reasonable basis, or in case of significant flaws in the methodology and model used, this constitutes a breach of that duty; (4) a rating agency may be liable for the total loss of an investor's investment if it has breached that duty; and (5) a rating agency may also be liable to investors if its rating is considered to be misleading or deceptive or its rating constituted a negligent misrepresentation.

⁹²¹ Harry Edwards (note 750) 95.

flaws in the model and in the inputs and assumptions adopted by S&P's to achieve its high rating.⁹²² The main question at stake was that the court had to establish whether on the basis of evidence there were reasonable grounds for issuing the ratings.

The Australian court found that manifest errors had been committed by the CRA in preparing its ratings: S&P's had relied on false information provided by the issuer itself without verifying it independently. S&P also knew or ought to have known of the misleading and deceptive nature of S&P's representations in connection with the 'AAA' rating.⁹²³

The ruling showed the fraudulent conduct of the CRA in misleading investors because of profits gained by the issuer. The CRA did not observe any duty of care to potential purchasers and created a potential distortion in the market by providing false statements as to the creditworthiness of financial instruments.⁹²⁴

S&P's authorized ABN Amro to disseminate an 'AAA' rating to market the constant proportion debt obligation ('CPDO') to potential investors, however 'no reasonable ratings agency exercising reasonable care and skill could have committed to the rating'.⁹²⁵ Further, the CRAs' disclaimers were not effective because they were not brought to the attention of investors, a fact that changed the position of CRAs liable for intentionally giving the investors a false representation of the quality of financial products.

The rating agency had neither asked sufficient questions nor sufficiently stress-tested the product—CPDO; its whole purpose was to have a triple 'A' rating while paying returns generally offered by a lower-rated product.⁹²⁶

This case established the false and negligent misrepresentations made by a 'reasonably competent' rating agency on the assessment of 'grotesquely complicated' securities. S&P's was paid by an issuer more interested in selling the

⁹²² Lesa Bransgrove, 'A risk too far: Lehman's Misseling' (2013) 87 *Law Institute Journal* 11, 53.

⁹²³ The court showed that 'S&P's knew that the rating was to be provided for the specific purpose of inducing potential investors to acquire the notes'. See *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200 at 2499.

⁹²⁴ The Australian Court stressed that the CRA had failed to exercise reasonable care to ensure that potential purchasers were provided with accurate information about the community income notes to enable them to properly understand the risk of financial losses to which purchasers of the notes were exposed.

⁹²⁵ *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200 at 2617.

⁹²⁶ 'Holding the rating agencies to account' *Financial Times* (London, 6 November 2012) 12. See also Stephen Foley, 'Rating agencies clash over standards' *Financial Times* (London, 6 November 2012) 33.

securities for the highest price than ensuring that investors had all the information they required to evaluate them. It is remarkable that ‘the Australian ruling marks the first time a rating agency has faced a full trial over a structured finance product’.⁹²⁷

The judge recognized the imposition of a duty of care on the rating agency whose opinion was supposed to be independent and competently reached, particularly where it is known that its purpose is to assist in the marketing of products to investors. It also recognized that rating agencies can be held liable for losses suffered by an investor who claimed that he relied on the rating given to an investment product. These considerations placed the litigation in the context of the common law tort of negligence as applied under the Australian Civil Liabilities Act 2002, rather than on a statutory cause of action.⁹²⁸

The key point is that a duty of care was owed to investors by the rating agency in the absence of privity of contract: a CRA has found to owe and have breached a duty to investors with whom it had no direct relationship. Moreover, the court established a duty of care for CRAs in a scenario of pure economic loss and recognized the ‘weakness’ of a claimant, in the sense that the investor was unable to protect itself from the CRAs’ negligence.⁹²⁹ However, this ruling contrasts with the orientation of UK and US courts, which are generally reluctant to allow claims in pure economic loss in the absence of a contractual relationship.⁹³⁰

Consequently, the Australian court afforded protection to ‘unaware victims’ of the CRAs’ negligent misrepresentation. The relevant point highlighted by Jagot, J. is that the CPDO was sold only to selected investors who were required to purchase only financial instruments that carried a certain rating, and that there was no secondary market for it.

⁹²⁷ Neil Hume, ‘Judge rules S&P misled derivative investors’ *Financial Times* (London, 6 November 2012) 17.

⁹²⁸ Section 5B(1) of the Australian Civil Liability Act 2002 (“General Principles”) under which ‘a person is not liable for harm caused by that person’s fault in failing to take precautions against a risk of harm unless (a) the risk was foreseeable (that is, it is a risk of which the person knew or ought to have known); and (b) the risk was not insignificant; and (c) in the circumstances, a reasonable person in the person’s position would have taken those precautions’.

⁹²⁹ *Woolcock Street Investments Pty Ltd v CDG Pty Ltd* (2004) 216 CLR 515; *Caltex Oil (Australia) Pty Ltd v The Dredge “Willemstaad”* (1976) 136 CLR 529.

⁹³⁰ *Anschutz Corp. v Merrill Lynch & Co., Inc.*, 671 F.3d 120 (2d Cir.2011). The claimant failed to state a claim for negligent misrepresentation under New York law because he alleged no relationship or contact with the Rating Agencies that could remotely satisfy the New York standard.

The Australian decision was based on two causes of action: (1) a statutory claim for damages alleging that S&P's had breached Sections 1041E and 1041H of the Corporations Act 2001⁹³¹ and Section 12DA of the Australian Securities and Investments Commission Act 2001⁹³² by engaging in misleading and deceptive conduct; and (2) a tort claim in negligence.⁹³³ In this context, Australia launched a vast programme of regulatory reforms, the "Future of Financial Advice reforms" (FOFA)⁹³⁴, aiming to enhance retail investor protection after the major domestic failures evidenced during the 2007-2009 financial crisis.⁹³⁵

Closer examination of the *Bathurst* judgment in terms of the heads on which the various parties were held liable shows that S&P's was sued for misrepresentation, negligence and breach of a fiduciary duty. In essence, S&P's failed to observe the duty of care owed to investors in assessing the financial products.

Under the misrepresentation head, the court revealed that S&P's based its rating of 'AAA' on assumptions that were substantially more favourable to the performance of the CPDOs than the actual economic conditions existing at the time. It was shown that S&P knew that councils were unsophisticated investors, and that the very reason why S&P was paid by issuers of a financial product to assign a rating for that product was because the rating is well known to be highly material to the decision of potential investors to invest.

Under the negligence and breach of fiduciary duty heads, the court found that S&P owed a duty of care to potential investors in the CPDOs. Specifically, the reason why ABN Amro obtained the rating was for distributing it to potential investors so that they could rely on the rating as an expert's opinion in respect to the creditworthiness of the CPDO notes. The court demonstrated that there was a breach of duty because S&P's did not have a reasonable basis to conclude that the notes fulfilled its own criterion for 'AAA' rating.

⁹³¹ Sections 1041E and 1041H of the Corporations Act 2001 (Act No. 50 of 2001 as amended).

⁹³² Section 12DA of the Australian Securities and Investments Commission Act 2001 (Act No. 51 of 2001 as amended).

⁹³³ Barbara McDonald, 'The legal framework of claims against ratings agencies in Australia' (2013) 28 *Journal of International Banking and Financial Law* 6, 383.

⁹³⁴ The FOFA legislation was passed by Parliament on 25 June 2012 and entered into force on 1 July 2012. See <<http://www.asic.gov.au/regulatory-resources/financial-services/future-of-financial-advice-reforms/fofa-background-and-implementation/>> accessed 26 November 2013.

⁹³⁵ 'Consumer protection became a prominent issue in Australia during the global financial crisis, due to a string of corporate collapses involving financial product and services providers, which resulted in large retail investor losses'. See Jennifer G. Hill (note 918) 271.

For the first time, the validity of CRAs' internal models by which credit rating agencies developed their reputation in the capital markets and also their legal immunity against investors was successfully contested and condemned.⁹³⁶

5.6 Implications of the Australian legislation for CRAs' liability

The *Bathurst* case brought to light the vulnerability of CRAs' activities, showing a remarkable understanding of the fact that credit rating agencies could be not considered a trusty benchmark of the quality of financial products.⁹³⁷ What is more, *Bathurst* represents a landmark case because it redefines credit ratings as advice rather than opinion. As Jagot, J. affirmed, '[the rating] was a record of an opinion of Standard & Poor's, which held itself out as having specialist expertise in assessing the creditworthiness of financial products and was intended to be understood as such'.⁹³⁸ This authority clearly constitutes a significant precedent against CRAs as it may open the door to further legal actions under negligent misrepresentation claims.⁹³⁹

The first instance judgment was upheld by the Federal Court of Australia confirming the existence of a duty of care for CRAs with respect to investors for a flawed triple 'AAA' rating given to a structured financial instrument.⁹⁴⁰ This judgment was mainly based on the assumption that it was reasonable for the

⁹³⁶ *Fait v Regions Financial*, 655 F.3d 105 (2d Cir. 2011) at 112. The US Court of Appeals for the Second Circuit held that statements in offering documents about goodwill and loan loss reserves constituted 'opinions' and that, as such, plaintiffs needed to show that the statements were both objectively false and subjectively disbelieved. By considering the position of credit rating agencies, the US court concluded that the ratings are 'fact-based opinions' and affirmed that the 'plaintiff is required to allege a speaker's disbelief in, and the falsity of, the opinions or beliefs expressed, ensures that their allegations concern the factual components of those statements'. Therefore, investors suing in federal courts are required to show that CRAs did not believe their own ratings at the time they issued them. For a commentary on this case, see Javier Bleichmar and Cynthia Hanawalt, 'The Evolving Legacy of *Fait v. Regions Financial*' (2013) 249 *New York Law Journal* 85.

⁹³⁷ Lisa McKenna, 'An Uncertain Forecast for Credit Rating Agencies: Liability for Negligent Misrepresentation after *Bathurst*' *Columbia Business Law Review Online*, 27 November 2012.

⁹³⁸ *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200 at 1277.

⁹³⁹ Nadine Schimroszik, 'S&P guilty of misleading investors. Landmark ruling by Australian court could pave way for flood of cases against ratings agencies' *The Guardian*, 5 November 2012.

⁹⁴⁰ *ABN Amro Bank NV v Bathurst Regional Council* [2014] FCAFC 65. The Federal Court of Australia rejected S&P's and ABN Amro's appeal against the 2012 ruling of the lower court. The decision on appeal delivered by Jacobson, J. confirmed that the rating agency was 'misleading' and 'deceptive' when it awarded an 'AAA' credit rating to a complex debt instrument. It should be noted that S&P's accepted on appeal that the rating was flawed.

investors to rely on the rating.⁹⁴¹ In particular, the Court of Appeal held that the rating agency knew that potential investors in a structured credit product would rely on its opinion as to the creditworthiness of the notes in making their decisions to invest.

The duty of care essentially flowed from a presumption that the councils fully depended on S&P's, the issuer ABN Amro and their financial services provider (Local Government Financial Services) in deciding whether to buy the products. The appeal judgment made it clear that a duty to exercise reasonable care and skill can be owed to third parties in circumstances where the precise identity of the recipient of advice is not necessarily known.⁹⁴²

Another relevant aspect considered by the Australian Federal Court was whether the damages awarded to the successful parties could be apportioned. On this point, the judges affirmed that 'the various claims pursuant to Section 1041E of the Corporations Act were apportionable under Section 1041L of Corporations Act because they arose out of the same facts as the claim under Section 1041H'.⁹⁴³

Although the Australian appeal decision confirmed the CRA's liability for negligent misrepresentation in the absence of a contractual relationship, the question of the best option to reduce investors' reliance on ratings is still far from

⁹⁴¹ Danielle Myles, 'Investors: curb your enthusiasm over S&P ruling' (2014) 33 *International Financial Law Review* 6.

⁹⁴² *ABN Amro Bank NV v Bathurst Regional Council* [2014] FCAFC 65, at 573 and 577. The Federal Court of Australia made it clear that 'to be a duty to exercise reasonable care in making a statement or giving advice: (1) the speaker must realise, or the circumstances must be such that the speaker ought to have realised, that the recipient of the information or advice intends to act on that information or advice in connexion with some matter of business or serious consequence; and (2) the circumstances must be such that it is reasonable in all the circumstances for the recipient to seek, or to accept, and to rely upon the utterance of the speaker'. The judge stated that 'it is not necessary that the person making the statement know the identity of the persons who may rely on it and suffer loss'.

⁹⁴³ *ibid* at 1245 and 1589-1590. In *Wealthsure Pty Ltd v Selig* [2014] FCAFC 64, the Federal Court of Australia considered the question as to whether the proportionate liability provisions in the Australian legislation apply in circumstances where a plaintiff has a number of causes of action against two or more defendants for the same loss or damage—notwithstanding that not all of the plaintiff's causes of action are apportionable claims. In this case, the Court held that the whole of the claim against *Wealthsure* should be apportioned, notwithstanding that the *Selig*'s claim had succeeded in other causes of action which were non-apportionable claims. In *Bathurst* and *Wealthsure* cases, the interpretation of Section 1041L(2) of the Corporations Act 2001 ('Division 2A--Proportionate liability for misleading and deceptive conduct') was determinant to affirm the proportionate liability regime under the Australian legislation. As a matter of clarity, Section 1041L(2) states that '(...) there is a single apportionable claim in the proceedings in respect of the same loss or damage even if the claim for the loss or damage is based on more than one cause of action (whether or not of the same or a different kind)'.

clear.⁹⁴⁴ By recognizing that investors were not able to ‘second guess’ the rating (nor undertake their own analysis of the notes’ default risk), this decision may encourage them to place greater reliance on credit ratings. This means that investors may be not stimulated to scrutinize the credit risk of the products they wish to buy.⁹⁴⁵

The role of CRAs with respect to investors was also explained in another Australian case where the judges contrasted the approach of English courts in *Cassa di Risparmio della Repubblica di San Marino v Barclays Bank* by taking into account the regulatory regime adopted in the Australian legislation.

In *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liquidation)*, the court held that the CRA had breached the fiduciary duties it owed with respect to local councils—as their investment adviser—by recommending products from which agency would receive significant fees and profits and that its conduct amounted to a breach of an Australian-specific consumer protection prohibition on misleading or deceptive conduct.⁹⁴⁶

The court found that the CRA engaged in misleading and deceptive conduct in breach of Section 12DA(1) of the Australian Securities and Investments Commission Act 2001 when it promoted that products to the councils as suitable investments.⁹⁴⁷ The case showed that rating agency was liable to compensate the councils for their losses incurred as a result of their investments. In particular, the relationship of Lehman Brothers with the investor was judged as being that of the

⁹⁴⁴ Harry Edwards, ‘S&P ruling: are CRA concerns justified?’ (2014) 33 *International Financial Law Review* 6. It is not entirely clear if this ruling incentivizes good ratings practice and how the decision addresses the main issues of CRAs’ activities.

⁹⁴⁵ *ibid.* The author points out that the better approach of making CRAs accountable for the role they play in financial markets is ‘to let the rating agencies’ reputational concerns (and therefore the credibility and value of their product) act to incentivize the maintenance of their standards’.

⁹⁴⁶ *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liquidation)* [2012] FCA 1028. In particular, the Federal Court of Australia held that Lehman Brothers Australia, which was called Grange Securities Ltd (Grange), was an investment adviser that owed to the councils fiduciary duties. The credit rating agency represented that its products—synthetic collateralized debt obligations (‘SCDOs’)—were prudent, capital protective investments and that they complied with statutory and council policy requirements. Also, the Court found that the SCDOs did not have the characteristics that Grange promised to the Councils they would have in their individual contracts: that is, the SCDOs did not have a high level of security for the invested capital, were not easily tradeable on an established secondary market or able to be readily liquidated for cash and were not suitable investments for risk-averse councils.

⁹⁴⁷ Section 12BAB of the Australian Securities and Investments Commission Act 2001 defines ‘financial service’ as ‘a recommendation or a statement of opinion, or a report of either of those things, that: (a) is intended to influence a person or persons in making a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products; or (b) could reasonably be regarded as being intended to have such an influence’.

councils' trusted adviser, so the court found that the councils acted on the adviser's recommendations and not on the documents containing the disclaimers.⁹⁴⁸ The significance of the decision is that the court focused on the mis-selling by Lehman Brothers in finding it liable for misleading and deceptive conduct, negligence, breach of contract and breach of fiduciary duty.⁹⁴⁹ Further, the *Wingecarribee* case underlined 'the potential limits of disclosure as a regulatory technique in the face of increased complexity of financial products'.⁹⁵⁰

The Australian legislation contains provisions that are intended to strengthen quality and integrity in the rating process, although the relevant rules are not specifically addressed to CRAs.⁹⁵¹ For example, Section 912A of the Corporations Act 2001 requires that credit rating agencies must act with due care, diligence and competence when preparing their ratings⁹⁵². In addition, the Australian Securities and Investments Commission (ASIC) removed the exemption held by CRAs of holding an Australian Financial Services License (AFSL) in order to improve controls on ratings industry.⁹⁵³

In this respect, CRAs issuing ratings without reasonable grounds may be subject to sanctions for engaging in misleading or deceptive conduct, or making false or misleading statements, in relation to financial services and products.⁹⁵⁴ These obligations are consistent with the existing principles and guidelines that require a CRA to employ analysts that are professional, competent, and of high integrity, via the general requirement for a financial services licensee to ensure that its representatives are sufficiently trained, and competent to provide the relevant financial services.⁹⁵⁵

⁹⁴⁸ Jennifer G. Hill (note 918) 275-276.

⁹⁴⁹ Lesa Bransgrove, 'A risk too far: Lehman's Misselling' (2013) 87 *Law Institute Journal* 11, 50. The author argues that 'this decision has serious ramifications for investors globally, both sophisticated and unsophisticated, and also for banks in terms of their potential liability and the need to redefine their capital-markets selling procedures'.

⁹⁵⁰ Jennifer G. Hill (note 918) 276 quoting Tony D'Aloisio, 'Regulatory Response to the Financial Crisis', Presentation delivered to the Asia Securities Forum, Sydney, 12 October 2009, 11-12.

⁹⁵¹ Graeme Baber, 'The role and responsibility of credit rating agencies in promoting soundness and integrity' (2014) 17 *Journal of Money Laundering Control* 1, 38.

⁹⁵² Section 912A(1)(b) of the Corporations Act 2001 (Cth).

⁹⁵³ Nick Sherry, 'Improved Australian Controls for Credit Rating Agencies and Research Houses', Press Release No 077, 13 November 2008.

⁹⁵⁴ Sections 1041E and 1041H of the Corporations Act 2001 (Cth), and Sections 12DA and 12DB of the Australian Securities and Investments Commission Act 2001 (Cth). On this matter see also IOSCO, 'Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies: Final Report', FR04/11, February 2011, 24.

⁹⁵⁵ Australian Securities and Investments Commission, *Outlines improvements to regulation of credit rating agencies in Australia*, 12 November 2009.

At this point, a relevant question is whether there is room for subsequent actions in which investors may run arguments similar to those which were successful under Australia law.⁹⁵⁶ For instance, it might be difficult to apply the *Bathurst* case under the new statutory cause of action established by the 2013 CRA Regulation. The Australian cases make rating agencies more aware of their accountability by affirming the principle that they are not legally immune for their opinions.⁹⁵⁷

In addition, the Australian judgments provide a means of dealing with the labyrinth of cases as decided over the past years in the US in which CRAs have not been held to account for their ratings in part because of the assumption that they are independent financial reporters.⁹⁵⁸ It can be claimed that rating agencies who have previously been unaccountable to investors may no longer be able to hide behind their disclaimers to protect them from liability.⁹⁵⁹ However, it remains to be seen whether such a claim would succeed in other common law jurisdictions generally less prone to accept the existence of the necessary relationship between the investor and rating agency (for example, the courts are unsympathetic to the idea that the rating agency owes a duty of care in issuing ratings even if in the absence of any contractual relationship).⁹⁶⁰ These claims could be decided on their individual facts with the risk of different judgments being given on the basis of the attitude, i.e. discretion, of the courts with respect of CRAs' business activities.⁹⁶¹

⁹⁵⁶ Jamie Smyth and Sam Fleming, 'S&P loses Australian appeal over misleading investors' *Financial Times* (London, 6 June 2014).

⁹⁵⁷ John Gapper, 'Safe harbour for ratings agencies gets smaller' *Financial Times* (London, 5 November 2012).

⁹⁵⁸ In particular, civil suits against rating agencies have been not successful and claims have been generally dismissed.

⁹⁵⁹ *Oddo Asset Management v Barclays Bank*, New York State Supreme Court, New York County (No 08-109547). The New York Court of Appeals dismissed a lawsuit against S&P's affirming that no fiduciary duty existed with respect to investors. See also *Boca Raton Firefighters & Police Pension Fund v Bahash, et al* (12-cv-1776) (US Court of Appeals for the Second Circuit) where the Second Circuit Court of Appeals dismissed a class action against McGraw-Hill concerning S&P's credit ratings for toxic mortgage-backed securities before the financial collapse. The US court found that S&P's statements regarding its independent and objective ratings were 'mere commercial puffery' and could not form the basis of a securities fraud claim.

⁹⁶⁰ By the same token, the courts could be unsympathetic to investors who make their investment decisions by placing sole or mechanistic reliance on the rating.

⁹⁶¹ See the case filed on 4 December 2013 in the District Court of Amsterdam by Stichting Ratings Redress (a Dutch foundation funded by Australian-based litigation funder, Bentham IMF Limited) where a group of 16 European institutional investors jointly sued Royal Bank of Scotland and S&P's for damages suffered as a result of investments made in complex financial derivatives known as Constant Proportion Debt Obligations ('CPDOs'). The investors allege that S&P's

The *Bathurst* case may be attractive for courts because of the re-characterization of ratings as factual representations rather than opinions, which would make it much easier to impose liability on credit rating agencies for negligent misrepresentation. However, this unprecedented decision may be undermined by CRAs' extensive explicit disclaimers of liability that could be an obstacle for changing the definition of a rating from an opinion to a representation (see 'Appendix IV').

In the *Bathurst* case, the judge made it clear that 'the disclaimers [of S&P's] were not effective in this instance because those disclaimers were not brought to the attention of investors. Where appropriate disclaimers are brought to the attention of investors, the position may be different'.⁹⁶² What is more, the different classes of investors (for instance if they are relatively sophisticated) may determine whether or not courts are willing to impose liability for negligent misrepresentation on ratings agencies.⁹⁶³

Lastly, the *Bathurst* case raises several questions about CRAs' *modus operandi* and increases the scrutiny of the credit rating agencies' gatekeeper role. However, the beneficial outcomes of this ruling will be determinable only after significant judicial review and rule-making.

Although this chapter has focused on CRAs accountability, the question of how regulators can tailor a proper responsibility to rating agencies remains unanswered. The developments in the case law under the Australian legislation have lifted the immunity that CRAs hitherto enjoyed (and elsewhere still enjoy) with respect to investors.

negligently assigned the highest 'AAA' rating to CPDOs, while heavily relying on misinformation supplied by RBS, the legal successor of the Dutch bank ABN Amro. The legal arguments and evidence raised in this case mainly follow the successful considerations established by the Australian Court judgment in *Bathurst* case.

⁹⁶² *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200 at 2541.

⁹⁶³ See the arguments of Jagot, J. based on the consideration that the municipal councils in *Bathurst* were relatively unsophisticated investors.

Chapter Six

Concluding Remarks

As stated by the one of the leading CRAs, ‘credit ratings are designed primarily to be our forward-looking opinions about creditworthiness and unlike other types of opinions, such as, for example, those provided by doctors or lawyers, credit ratings opinions are not intended to be a prognosis or recommendation’.⁹⁶⁴ On this view, CRAs are primarily intended to provide investors and market participants with information about the relative credit risk of issuers and individual debt issues that the agency rates.⁹⁶⁵

However, recital 8 in the preamble to Regulation No 462/2013 states that ‘credit ratings, unlike investment research, are not mere opinions about a value or a price for a financial instrument or a financial obligation. Credit rating agencies are not mere financial analysts or investment advisors. Credit ratings have regulatory value for regulated investors, such as credit institutions, insurance companies and other institutional investors’.

By summarizing the outcomes of research, this study analyses the liability of CRAs in the financial markets and the implications of CRAs’ *modus operandi* for regulators and market participants.

Chapter one explored the main features of the ratings industry taking into consideration the major problems involving the CRAs in the aftermath of 2007-2009 financial crisis. In considering the CRAs’ failures and remedies, the chapter provided tentative proposals for strengthening the legal framework of CRAs.

Chapter two provided a thoroughly discussion about the governance of CRAs with particular emphasis on their business model, underlying the potential collusive behaviour between issuers and raters. Further, the focus on ratings methodologies, conflicts of interest and CRAs’ ownership raised concerns about the lack of transparency and limited competition in the ratings industry. To

⁹⁶⁴ S&P’s, ‘Guide to Credit Rating Essentials. What are credit ratings and how do they work?’ (2011) <www.standardandpoors.com> accessed 1 March 2012, 3.

⁹⁶⁵ See Comments of Moody’s Investors Service to the Securities and Exchange Commission following the Credit Ratings Roundtable held on 14 May 2013, 3 June 2013, where it is stated that ‘ratings should be treated as opinions forecasts on credit risk, and should not be used by regulators to oversee other industries or sectors’.

address these problems a viable solution lies in the establishment of independent controllers, i.e. compliance bodies, with tasks of verifying the information used in the rating process.

The use of rating triggers in the financial transactions, the role of sovereign ratings and the question of over-reliance on CRA ratings has been analysed. The results evidenced the presence of wrong incentives in the CRAs market namely ‘reputational capital’ and ‘regulatory licenses’: these incentives favour the phenomena of ‘rating shopping’ and ‘rating inflation’.

Chapter three examined the regulatory structure of CRAs with regard to the international approach and the legislative reforms adopted in the US and the EU. This analysis showed a persistent gap in the supervision and enforcement of CRAs’ activities: although the legislators have improved the monitoring system and increased the disclosure regime, the conduct of the main CRAs has remained intact.

Chapter four dealt with the accountability of CRAs: the central idea is to hold the credit agencies liable for their erroneous ratings. It is argued that to bridge this gap a viable solution lies in the application of estoppel doctrine, i.e. estoppel by representation, as a rule of evidence in demonstrating a fact necessary to prove a cause of action.

Chapter five discussed the fact that the expert liability established in the Dodd-Frank Act 2010 and the civil liability regime introduced in the 2013 EU Regulation did not resolve the lack of a unique, single system of responsibility for CRAs. Further, the tort liability regime put in place at the EU level differs from the UK tort law, which is essentially based on the existence of a duty of care and the causal link between the wrongful act or omission and the damage.

The story of CRAs is a curious one. Over the last decade, CRAs have given rise to a heated debate among academics, practitioners and their designated users (i.e. issuers and investors) about both the very idea of having a strong regulatory framework and how this would work in practice.⁹⁶⁶

This thesis sets out to show that market participants did not understand either the powerful role played by CRAs in the capital markets or how the ratings industry affects the legal and economic aspects of financial regulation. CRAs’

⁹⁶⁶ Charlotte Eborall, ‘Credit Rating Agencies’ in Michael Blair, George Walker and Stuart Willey (eds), *Financial Markets and Exchanges Law* (2nd edn, Oxford: OUP 2012) 549-550.

activities influence not only investor behaviour but also the stability, i.e. integrity, of the securities sector.

The 2007-2009 financial crisis revealed glaring shortcomings of CRAs in providing independent and accurate evaluations of the creditworthiness of firms and structured finance products (e.g., the Lehman Brothers and subprime mortgages cases).⁹⁶⁷ For instance, CRAs failed to anticipate the seriousness of the bursting of the housing bubble in the US or to recognize the poor quality of the subprime loans packaged into securities.⁹⁶⁸ In this regard, the research underlines the need to address the main problems in connection with the CRAs' *modus operandi* namely: (1) the 'issuer-pays' business model; (2) over-reliance on ratings for regulatory purposes and on the part of investors; (3) limited competition; and (4) lack of responsibility.

In academic circles, it is commonly observed that the main CRAs have been elevated to the centre of the international financial architecture by lawmakers and regulators. These NRSROs have the power to label bonds for issuance firms. They act as gatekeepers by regulating the flow of market-sensitive information. As a result, credit ratings became a crucial reference for the banking and financial system, playing a 'certification' role that has created conflicts of interest between CRAs and issuers and high barriers to entry to additional competitors, while the CRAs enjoyed immunity from liability. Fair competition could reduce the phenomenon of ratings shopping and may reduce monopolistic or oligopolistic rents, and add information to financial markets since raters sometimes give different ratings.

In this regard, the research shows that the CRAs are to be blamed for misjudging the safety of securities products which ultimately proved toxic for banks and investors. CRAs need to be held accountable but the present regulatory framework does not secure adequate protection for market participants. Although several legislative reforms have been adopted, there is a strong argument that lack of rules of the game is the major factor in the accountability regime of CRAs.

⁹⁶⁷ Rating agencies have been criticised because of their failure properly to evaluate the risks embedded in mortgage bonds during and following the 2007-2009 financial crisis. See Kara Scannell, 'S&P faces securities fraud charges over mortgage ratings' *Financial Times* (London, 23 July 2014).

⁹⁶⁸ S&P's faced a US Department of Justice lawsuit over 'rosy' ratings. In particular, the leading credit rating agency has come under scrutiny for allegedly giving over-generous ratings to structured credit products, including collateralized debt obligations, in order to win fees.

Further, CRAs were responsible for delaying downgrades of sovereign default risks (for example, in the 2011-2012 Greek debt crisis).⁹⁶⁹

The problem is made worse by the fact that investors find it difficult to choose the right financial product because there is no appropriate system of disclosure and the internal control rules are inadequate. Market participants mechanistically rely on ratings, thus causing hazardous behaviour such as sell-offs of securities when they are downgraded, so-called ‘cliff effects’, that can determine procyclicality and systemic risk.

All this underscores the failings of the ‘issuer-agency’ relationship that characterizes the ratings business model.⁹⁷⁰ This relationship is fraught with major conflicts of interest because, when it comes to ratings, the issuers’ purposes often do not square with investors’ need to receive reliable ratings information.⁹⁷¹ However, it is not entirely clear why professional intermediaries favour this payment structure when their main task is to assess publicly available information—through independent opinions—in order to help investors in making their own investment decisions.⁹⁷²

The research identifies the potential conflicts of interest exhibited by CRAs because they have a financial incentive to accommodate the preferences of bond issuers, owing to the fact that the agencies are selected and paid by the issuers. This heavy dependence gives rise to ratings inflation and inaccuracy.

To address the question of conflicts of interest, disclosure of each rating grade should be verified by independent bodies and not by the raters themselves. This

⁹⁶⁹ Article 8(5) of Regulation (EC) No 1060/2009. What is more, Regulation (EU) No 513/2011 added in Article 8(5) the following paragraph: ‘sovereign ratings shall be reviewed at least every six months’. See also Sophia Grene, ‘Big three credit rating agencies under fire’ *Financial Times* (London, 4 May 2014).

⁹⁷⁰ Francesca Gennari and Luisa Bosetti, ‘The Governance of Credit Rating Agencies in the European Regulation: The Right Way to Enhance Market Competition?’ (2011) 2 *International Journal of Contemporary Business Studies* 7, 17.

⁹⁷¹ Tracy Alloway, ‘Moody’s in new conflict of interest claim’ *Financial Times* (London, 30 July 2014), where it is noted, according to academic studies, that in the years following the financial crisis Moody’s showed ‘favouritism towards its top shareholders when rating the bonds of companies’.

⁹⁷² Lawrence J. White, ‘A New Law for the Bond Rating Industry -- For Better or For Worse?’ (2007) New York University School of Law, Law & Economics Research Paper Series Working Paper No 07-09 <<http://ssrn.com/abstract=961391>> accessed 26 November 2013, 7-8. The author argues that ‘the bond ratings help lenders (bond investors) pierce the fog of asymmetric information so as better to determine the creditworthiness of potential borrowers (bond issuers), while also providing the opportunity for the more creditworthy borrowers to stand out from (and pay lower interest rates than) their less creditworthy peers’.

means that independent controllers should manage publicly available information before it is used in a rating assessment.

CRA's have acknowledged the existence of the 'issuer-pays' conflict of interests and the more benign risk of error, but have typically downplayed their significance, stating that their reputations are far too valuable to the success of their businesses for them either to succumb to the biases inherent in the issuer-pays revenue model or to issue inaccurate ratings. Individual investors rely on the ratings because of their perceived authority, while institutional investors rely on them because of their market authority.

The fact that public regulators are apt to delegate regulatory authority to credit rating agencies—in order to improve market efficiency by making use of their informational advantage—could determine a potential cause of distortion in the financial sector.⁹⁷³ Rating conflicts of interest, if not adequately addressed, constitute an evident 'market failure' of securities regulation. Since issuers pay the bills and still get to pick which agency rates their debt, attempts to strip credit ratings of their central role in financial regulation will prove to be complicated.

In examining the normative framework for CRA's, this research raises an important question: whether the paradoxical position of credit rating agencies as financial arbiters can be regarded as being a lack of market discipline or a regulatory failure. In order to respond to this question, the analysis sets out tentative suggestions for implementing the present accountability regime by making CRA's liable for issuing inaccurate ratings. The fact that CRA's successfully escape responsibility can determine an inefficiency of resource allocation. Such inefficiency may be correlated with the risks of incomplete information being supplied to investors.

The critical problem is that credit ratings affect market confidence and influence both investment decisions and expectations. As intermediaries, credit ratings should profit from protecting investors because they manage 'market information', which is generally considered to be a public good. Through their trustworthy reputation they constitute suppliers of independent information for investors. Investors—as market participants—should be made aware of the

⁹⁷³ Tracy Alloway, 'MBS deal shelved after rift over ratings' *Financial Times* (London, 12 May 2014). The author observes that 'since the financial crisis, regulators have encouraged credit rating agencies to give "unsolicited" opinions on deals that they are not hired to evaluate, as part of an effort to avoid the ratings shopping that proliferated before 2008'.

uncertainties surrounding future predictions of default events. So there is a public interest in achieving accountability for this publication of results.

CRA's wield great power to influence market fluctuations in securities and investors' decisions through their evaluations. The risk of such influence should be addressed by a regulatory framework guaranteeing responsibility and accountability for CRA's evaluations.

Although the role played by CRA's is considered to be valuable by issuers and investors their involvement in debt securities' regulation has generated a demand for ratings that is associated with the need to comply with such regulation and not necessarily with the quality of ratings.⁹⁷⁴ The fact that financial products need to be labelled in order to ensure that substantial revenues accrue to companies goes hand-in-hand with a high demand for CRA's.

As a result, the regulatory use of ratings may give rise to a systemic risk, namely the risk of market and regulatory failures. This research supports the argument that CRA's should be regulated having due regard to their potential systemic threat and should be subject to professional standards similar to those applicable to other information intermediaries, such as auditors and financial analysts.

Adequate investor protection against market distortions requires trustworthiness and reliability. Consequently, CRA's should encourage 'market efficiency' through their gatekeeper role. There is large consensus among policymakers to the effect that references to CRA's in securities regulation should be reduced and 'to make sure there is less damage the next time that the agencies miss, for example, a whopping crisis in the making'.⁹⁷⁵

The research has sought to demonstrate that 'reputational capital' and reputation alone are not a workable constraint on the gatekeeper function. On the one hand, market incentives alone seem to be inadequate to foster the accuracy of ratings and to keep the effectiveness of CRA's' action aligned with investor

⁹⁷⁴ John Authers, 'Rules shake-up and the law of unintended consequences' *Financial Times* (London, 1 June 2014). It is observed that 'the all due diligence to credit rating agencies was effectively outsourced by rules such as the Basel II bank regulatory regime. The agencies, unready to play the large role allotted to them, were swamped and fatefully allowed the bubble in structured mortgage debt'.

⁹⁷⁵ Stephen Foley, 'Issuer payment: model resistant to reform' *Financial Times* (London, 14 January 2013).

protection. On the other hand, regulation has increased the incentives to shop for ratings by allowing agencies to be used for regulatory purposes.

For this reason, securities regulation can be considered a victim of market failure and regulatory failure in the ratings industry. In particular, the question of CRAs' conflicts of interest and the over-reliance on ratings highlight what kind of regulatory tools are needed in order to enhance rating agencies' activities.

The CRAs not only should put proper arrangements in place to ensure high standards of disclosure, but should also enable investors, by means of financial knowledge, to comprehend their internal procedures (e.g. 'investment grade').⁹⁷⁶ In other terms, CRAs should improve the incentives to supply complete available information to market participants.

A major task for CRAs is to improve investor protection by requiring greater transparency.⁹⁷⁷ In this regard, the recent case law closely considered the role of CRAs with respect to investors (for example, the recent Australian decision in the *Bathurst* case). These rulings found that CRAs should be made responsible for their investment certification because of their fundamental role in evaluating credit risk and influencing investors' confidence.

At the institutional level, the government initiatives—the adoption of Regulation (EU) No 462/2013 and Dodd-Frank Act—have improved transparency and fairness of CRAs by creating a challenging system of regulation and supervision. This system enables the rating industry to deliver services considered indispensable but, as far as possible, prevents them from pursuing activities that are deemed detrimental to consumers.⁹⁷⁸

More disclosure and transparency of CRAs activities make important sense in the current regulatory framework. A regulatory environment that enforces accurate financial disclosure by firms wishing to issue securities also helps to enhance the flow of reliable information to investors. Transparency should improve rating reliability, facilitate investor diversification and decrease market

⁹⁷⁶ Marilyn Blumberg Cane, Adam Shamir and Tomas Jodar, 'Below Investment Grade and Above the Law: A Past, Present and Future Look at the Accountability of Credit Rating Agencies' (2012) 17 *Fordham Journal of Corporate & Financial Law* 4, 1090-1091.

⁹⁷⁷ Maurice Mullard, 'The Credit Rating Agencies and Their Contribution to the Financial Crisis' (2012) 83 *The Political Quarterly* 1, 93.

⁹⁷⁸ Stefanie Hiss and Sebastian Nagel, 'Credit Rating Agencies' in Daniel Mügge (ed.), *Europe and the Governance of Global Finance* (Oxford: OUP 2014) 140.

uncertainty. CRAs provide influential information to market participants and need to be pressurized to provide adequate disclosure about their own methodology.

The research shows that these regulatory measures could prove to be ineffectual because rating methods necessarily evolve over time to reflect innovations by underwriters, new legislation and changes in the financial market.

The CRAs' watchdog would have the difficult task of enforcing ratings uniformly, potentially preventing laxer jurisdictions from undermining common standards and limiting the ability of certain jurisdictions to add additional requirements.⁹⁷⁹ As for the scope, the on-going discussion as regards regulatory choices (i.e. civil liability) will need further attention. A number of technical adaptations appear useful even against the background of the current choices made.

It is important that market discipline should detect the potential distortions of CRAs' activities and provide the right incentives to stimulate the rating agencies to perform objective and accurate evaluations. What is crucial for the operation of the legal protection for investors is the soundness of CRAs' actions in interpreting disclosed information and assessing the creditworthiness of companies, thereby increasing investor confidence.

In other words, investors should be ensured of the appropriate level of information on which to make decisions. For this reason, a possible solution is to reduce the importance of CRAs by eliminating the 'references' to credit ratings in the regulations⁹⁸⁰: this means letting CRAs do their job without giving them the 'certification role' of the quality of financial products.

It is evident that some individual investors are unskilled and make poor decisions about risk even when they have obtained full information about the products. In order to avoid failures on the part of CRAs, it is necessary that these agencies perform their role of promoting financial awareness while being accountable for their opinions, since they are more than simple opinion providers. As has been noted, 'agencies are not just analysing and rating bonds for the sake

⁹⁷⁹ Brooke Masters, 'Rating agencies fall under EU supervision' *Financial Times* (London, 31 October 2011).

⁹⁸⁰ FSB, 'Thematic Review on FSB Principles for Reducing Reliance on CRA Ratings. Peer Review Report', 12 May 2014.

of self-expression and because they enjoy it. They are being paid to do so by the issuers of bonds'.⁹⁸¹

Bonds need ratings in order to be sold: in the case of structured bonds, the pools of debt could be arranged or modified in order to obtain a favourable rating, a sort of game to get the approval of a leading CRA.⁹⁸² In this way, ratings have become the arbiter of any securities transaction as well as an essential service for clients: the global financial markets have credit ratings hard-wired into them, and it seems difficult for regulators to push for changing the 'ratings game'.

With these considerations in mind, it is possible to conclude that although the recent failures showed the potential lucrative purposes of CRAs business, their output remains central to the functioning of the financial system.⁹⁸³ By being the ones that allow an entity to be able to meet the requirements imposed by regulators, their role is vital since they are required in order to access the capital markets.

⁹⁸¹ John Gapper, 'Rating agencies must beware of the law' *Financial Times* (London, 6 February 2013).

⁹⁸² Sam Jones, 'From AAA to AAAaaarrghhhh. How the credit rating agencies' triple-A scores went bad – and took the financial system with them' *Financial Times Weekend Magazine* (London, 18/19 October 2008) 19.

⁹⁸³ FSB, 'Credit Rating Agencies. Reducing reliance and strengthening oversight', Progress Report to the St Petersburg G20 Summit, 29 August 2013, 2. The Report affirms that 'CRAs play an important role and their ratings can appropriately be used as an input to firms' own judgement as part of internal credit assessment processes'.

Appendix I

Long-Term Rating Scale

S&P's	Moody's	Fitch
AAA Highest ratings	Aaa Highest quality ratings	AAA Highest credit quality
AA High Rating	Aa High quality ratings	AA Very High Credit
A Strong Rating	A Upper-medium Ratings	A High Credit Quality
BBB Adequate Rating	Baa Medium-grade ratings	BBB Good credit quality
BB Vulnerable Rating	Ba Speculative ratings	BB Speculative
B More vulnerable Rating	B Speculative ratings	B Highly speculative
CCC Currently Vulnerable Rating	Caa Speculative of poor standing ratings	CCC Substantial credit risk
CC Currently High Vulnerable Rating	Ca Highly speculative	CC Very high levels of credit risk
R Under regulatory supervision Rating	C Lowest ratings	C Exceptionally high levels of credit risk
SD/D Selective default/default Rating		RD Restricted Default
NR Issuer not rated		D Default Ratings

Source: Compiled by the author using data from Moody's Investors Service, 'Rating Symbols and Definitions', August 2014, 5; Fitch Ratings, 'Definition of Ratings and Other Forms of Opinion', January 2014, 9-10; Standard & Poor's, 'Standard & Poor's Ratings Definitions', 22 September 2014 <www.standardandpoors.com> accessed 1 October 2014. S&P's makes clear that the ratings from 'aa' to 'ccc' may be subject to a plus (+) or minus (-) sign to show relative standing within the major rating categories.

Appendix II

Definitions of Ratings

Short-term credit ratings	A short-term issuer or obligation rating is based, in all cases, on the short-term vulnerability to default of the rated entity or security stream and relates to the capacity to meet financial obligations in accordance with the documentation governing the relevant obligation.
Medium-term credit ratings	Long-term credit rating is designed to evaluate the up-to-one-year expiration obligations
Long-term credit ratings	Ratings of individual securities or financial obligations of a corporate issuer address relative vulnerability to default on an ordinal scale.
Default ratings	Assessment the default risk of an issuer
Recovery ratings	Measure of the expected recovery rate when default has occurred
Credit conversion factor ratings	Provide an ordinal opinion on the exposures prospects
Expected loss ratings	Measure of the average losses occurred due to default in a portfolio
Local currency ratings	Local currency rating evaluates an obligor's capability of generating sufficient local currency in order to meet its domestic currency financial obligations
Foreign currency ratings	Foreign currency rating evaluates an obligor's ability to service foreign debt commitments taking into account the access to foreign exchange
National scale ratings	Denote the quality of the issuer/issue relative to others within a specific home market
Stand-alone ratings	Reflect the issuer's financial strength and creditworthiness without any intervention from the state, shareholders or stakeholders
Claims payability and deposit ratings	Provide a view on the ability of an insurance organisation to fulfil its insurance policies and contracts under the agreed terms
Municipal ratings	Express an opinion on the investment quality of US and EU municipal and tax-exempt issuers and issues
Support ratings	Indicate a judgement of a potential supporter's propensity and ability to support a bank facing difficulties
Country and country ceiling ratings	Represent a country's relative credit risk and serve as an important guideline for foreign investments and final decisions

Source: Compiled by the author using data from Fitch, 'Definitions of Ratings and Other Forms of Opinion' (December 2011) <www.fitchratings.com> accessed 6 March 2012, 18; Tony Van Gestel and Bart Baesens, *Credit Risk Management* (Oxford: OUP 2009) 137.

Appendix III

Rating qualifiers

“pi” ratings	Ratings based only on published financial information.
“q” ratings	Ratings based on a statistical rating model that is fed with ratios and variables derived from the financial statements.
“p” ratings	Ratings based on the likelihood of repayment of the principal portion of the obligation only.
“i” ratings	Ratings based on the likelihood of repayment of the interest.
“pr” ratings	Provisional ratings based on the credit quality assuming that the rated project is successfully completed.
“t” ratings	Ratings based on the termination structures that are designed to honour their contracts at maturity or before.
“*” ratings	Ratings based on a shadow opinion or conditional rating that are not intended for publication.

Source: Compiled by the author using data from Tony Van Gestel and Bart Baesens, *Credit Risk Management* (Oxford: OUP 2009) 119-120.

Appendix IV

Credit Rating Agencies Disclaimers

Standard & Poor's

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