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RATING AGENCIES

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RATING AGENCIES

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Abstract

This chapter attempts to capture the global regulatory response initiated against rating agencies in the aftermath of the Global Financial Crisis, and its implication on the rating industry. Section II starts with an outline of the role and influence of rating agencies in the financial market, and attempts to understand their role in the financial debacle. Section III examines the emerging regulatory and supervisory framework for rating agencies. Section IV provides special focus on the emerging civil liability regime from a historical perspective. Emphasis shall be placed on the practices and regulatory interventions in the US and the Europe as they have set a trend followed by other countries.

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I. Introduction

Rating agencies are key players in the financial system. They provide independent assessment on the creditworthiness of debt issuers' to make an informed decision in the financial markets. The rating agencies have,overtime, become the 'gatekeepers' of financial and capital market, a position of considerable power and influence. In the opinion of the United States (US) Congress, "the credit raters . . .hold the key to capital and liquidity . . .the lifeblood of corporate America and of our capitalist economy.The [rating affects] a company's ability to borrow money. It affects whether a pension fund.., or a money market fund can invest in a company's bonds, and it affects stock price"[1]. In the absence of a national and international regulatory framework, the three major rating agencies – Moody's,Standard & Poor's (S&P)and Fitch Ratings– have dominated for decades the rating industry globally.

The US subprime crisis and the sovereign debt crisis in Europehave exposed the questionablerole played by the rating agencies in accelerating the crisis. Government committee and independent studies found that the rating agencies have knowingly inflated credit ratings of structured financial products for profit and market domination. The decision to downgrade sovereign states without sound basis, and in turn, plunging financial markets into a state of profound distress have widely questioned the integrity and accuracy of such ratings. Policymakers from both sides of Atlantic have responded with a series of regulatory interventions with far-reaching consequence on the agencies'.Led by the US, European Union (EU)and other international agencies such as the Group of Twenty (G20), emphasis has been placed on regulating the raters calling for a strong supervisory oversight of rating agencies[2].

This chapter attempts to capture the regulatory response initiated against rating agencies post Global Financial Crisis at both the national and international level, and its implication on the rating industry. Section II starts with an outline of the role and influence of rating agencies in the financial market, and attempts to understand their role in the financial debacle. Section III examines the emerging regulatory and supervisory framework for rating agencies. Section IV provides special focus on the emerging civil liability regime from a historical perspective. Emphasis shall be placed

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[1]Rating the Raters: Enron and the Credit Rating Agencies: Hearing Before the Senate Comm. on Governmental Affairs, 107th Cong. p. 2 (2002).

[2] See The G20 Los Cabos Declaration, June 2012. See also "Benchmarks and Credit Rating Agencies" G20 High-Level Seminar, St.Petersburg June 4, 2013.

on the practices and regulatory interventions in the US and the Europe asthey have set a trend followed by other countries.

II. Role of Credit Ratings in the Financial System

Ratings are essentially grades given by credit rating agencies (CRAs) based on the performance of the debtor's bonds and other debts for use in investment decisions and are found to be important for management of both corporate and sovereign credit risk[3].The European Communities (EC) defines credit rating as "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"[4]. The publication of specialized, independent and prospective assessments on debt issuers' creditworthiness, the CRAs reduce information cost asymmetry that exists between the investor/lenders and the debt issuers, increase the pool of potential lenders/borrowers and promote liquidity in markets[5].

II.1 Credit Rating Definitions and Principles

The rating agencies provide standardized, easy to understand, independent third party assessment of quality of the creditworthiness and credit risk associated with bonds and other financial products[6]. Credit risk is "the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time"[7]. The creditworthiness is expressed in a letter grade which has got concretized by the rating agencies over a period of time[8]. The letter grades would range from 'AAA' to 'D' to communicate the agency's opinion of relative

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[3] Takashi Kubota, "Enhancing the Transparency of Japanese Financial Laws: the Case of Oversight of Credit Rating Agencies" (2010) 53 *The Japanese Yearbook of International Law*, p. 344. See also Role and Function of Credit Rating Agencies in the U.S. Securities Markets, U.S. Securities and Exchange Commission Public Hearing, November 15, 2002, http://www.sec.gov/news/extra/credrate/standardpoors.htm.

[4] Article 3 (a), EC CRA Regulation No 1060/2009.

[5]Ibid., N. Petit, "Credit Rating Agencies, the Sovereign Debt Crisis and Competition Law" (2011) 7 (3) *European Competition Journal*, p. 588. L.J. White, "The Credit Rating Industry: An Industrial Organization Analysis", paper presented at the *Conference on The Role of Credit Reporting Systems in the International Economy*, The World Bank, Washington D.C., 1-2 March 2001, p. 4.

[6] CRAs opine on the creditworthiness of "bonds, preferred stock, and commercial paper." Credit Rating Agencies—NRSROs, U.S. SEC, See http://www.sec.gov/answers/ nrsro.htm. See also *Report: Watchdog*, infra note 8 at 77.

[7] See S&P, "Guide to Credit Rating Essentials", http://img.en25.com/Web/StandardandPoors/SP_CreditRatingsGuide.pdf

[8] Moody's Investors Services gave letter grades ratings to nearly all the government bond markets comprised mostly of railroad bond issues in 1909. Moody's credit ratings were followed by Poor's in 1916, Standard in 1922, and Fitch in 1924.See Staff of the Senate Comm. on Governmental Affairs, 107th Cong., Report on the Financial Oversight of Enron: The SEC and Private-Sector Watchdogs (Comm. Print Oct. 7, 2002) (hereinafter *Watchdog Report:*) at 77.

level of credit risk and the likelihood of default and financial loss in the event of such default[9]. There are slight variations in the way each CRAs provide their guidance. For instance, the are nine symbols used by Moody's - AaaAa A Baa Ba B CaaCa C - are used to designate the least credit risk to that denoting greatest credit risk. Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa.[10] Whereas, S&P and Fitch use a similar ratings system, slightly modified from Moody's.

Broadly, the letters representing a category indicate similar credit characteristics. The first four categories, AAA through BBB ratings in the case of S&P and Fitch[11] (Aaa through Baa for Moody's) are considered "investment grade" or of good or better credit quality, with AAA+ representing the highest credit quality and BBB- representing the lowest investment grade credit quality[12]. It is perceived that the AAA rating, which represents the highest quality, are immune to any risk, except the worst cyclical shock, like another Great Depression[13].Rating BB and below are considered speculative quality indicating that a company is of "speculative grade" or "junk", meaning, a debt security where the issuer currently has the ability to repay but faces significant uncertainties[14]. The lower ratings indicate vulnerability and significant likelihood of some default. The letter-grade ratings can be revised and reevaluated at periodical intervals. Before the rating agency is to lower or raise a rating, they may put the companies/states "on review" (Moody's) or "credit watch" (S&P) or "ratings watch" (Fitch) with a negative or positive outlook[15].

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[9] "Rating Symbols & Definitions," Moody's Investors Service (July 2010), http://v3.moodys.com/.sites/products/AboutMoodysRatingsAttachments/MoodysRatingsSymbolsand%20Definitions.pdf; "Understanding Standard & Poor's Rating Definitions," Standard & Poor's (June 3, 2009), http://www2.standardandpoors.com/spf/pdf/fixedincome/UnderstandingRating_Definitio ns.pdf.

[10] "Ratings Definitions: Issuer Ratings," http://www.moodys.com.

[11] "Fitch Ratings Definitions: Issuer Financial Strength Ratings," http://www.fitchratings.com."Introduction to Moody's," http://www.moodys.com.

[12] Rating Symbols & Definitions, supra note 9.

[13] Thomas P. Au, A Modern Approach to Graham and Dodd Investing (John Wiley and Sons, 2004), p. 52 See also "The Desired Meaning of Triple-A," Ex. 689 at MDYS ADCB 936594, in Abu Dhabi Commercial Bank, et al vs. Morgan Stanley & co. et al US District Court Southern District of New York, Opinion and Order, 08 Civ. 7508 (SAS) August 17, 2012, p. 74, http://www.sdnybusinesslitigationblog.com/Files/Abu-Dhabi-Commercial-Bank-v.-Morgan-Stanley-17-Aug-2012-opinion.pdf.

[14] *Rating Symbols & Definitions,* supranote 11. See Guide to Credit Rating supra note 7, p. 11, http://img.en25.com/Web/StandardandPoors/SP_CreditRatingsGuide.pdf. See also *Report: Watchdog* supra note 8 p. 77

[15] *Report: Watchdog* supra note 8 ibid.

The rating agencies consider their ratings only as an "opinions" about credit risk,[16] which are forward looking, meaning, "the evaluations are based on current and historical information, and assesses the potential impact of foreseeable future events"[17]. S&P explains, "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 to buy, sell or hold a security"[18]. The rating can be used to making long or short-term investment and business decisions, however, there is no guarantee that an investment will pay out or that it will not default. Despite these riders, the rating agencies and ratings have over the years, accumulated enormous reputational capital that they are infallible in their assessment of credit risk. For this reason, investors follow the rating blindly and a company or financial product with poor rating would find hard to raise capital because of investors' reluctant to invest in high risk products and low rating often means high interest rates on loans.

Revenue model

The rating agency's rating could be broadly classified into unsolicited and paid ratings. Unsolicited ratings are assessments of creditworthiness without involving the issuer and the assessment is shared with the public at large. The core aspect of this service is that neither the public (both individual and institutional investors) nor the issuers of debt instruments (companies/states) pay the agency for such rating. The rating agencies generally depend on information in the public domain while rating. On the other hand, in paid service the agencies typically receive payment for their services either from the issuer under who's request the risk is assessment or from the subscribers who receive the published ratings and related credit reports.

Since the beginning of the rating industry,revenue was generated by selling information to interested investors via a "user-pay" revenue model, i.e., the investor pays a fee to the rating agency to access information[19]. In 1975, the CRAs shifted to an"issuer-pay" model, wherein the agency charged the issuers for rating their creditworthiness[20]. Under this model, risk is assessed and ratings given at the request of the issuers of debt instruments. The agencies shall factor in their ratings

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[16] See Guide to Credit Rating supra note 7. Marwan Elkhoury Credit Rating Agencies and Their Potential Impact on Developing Countries, UNCTAD Working Paper No. 186 January 2008, UNCTAD/OSG/DP/2008/1, p. 2 http://unctad.org/en/Docs/osgdp20081_en.pdf.
[17] Guide to Credit Rating, supra note 7, p. 4.
[18]Ibid, p. 3.
[19]Crawford &Wolfson*,* p.86.
[20]Ibidp. 87. The "user-pay" model became untenable for two reasons. First, inexpensive copying created a "free rider" problem. Second, intense demand for credible ratings required expensive teams of highly skilled analyst. See Carol Ann Frost,"Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies" (2007) 22 *Journal of Acct. Auditing & Fin.* pp.478–479.

information received independently along with information obtained from issuers that might not otherwise be available to the public. The ratings are publicly disclosed free of charge[21]. By charging the borrower for their service rather than the investor community, the rating agency effectively spreads the cost of the ratings evenly across investors[22].

The "user-pay" revenue model, on the other hand, remained in practice and was not totally discarded. Some of the recent debt rating industry entrants make their assessments available only by subscription[23].These are essentially "private subscription" services dealt under confidentiality agreement available only to subscribers by charging a fee for access to the agency's ratings, generally for large institutional investors.

II.2 Rating Agencies as *de facto* regulators

Historical context

The rating agencies as is known today have been around for more than a century. John Moody, the founder of Moody's Investors Service, is generally credited with devising credit ratings for public debt issues since the beginning of the 20th Century[24]. In 1909, Moody entered the business of analyzing stocks and bonds of American railroad.[25]His rating system was the first to assign letter grades in declining order of credit quality.[26] Before Moody's invented the letter based credit rating, H.V. and H.W. Poor Co., in 1868, John Moody & Co. in 1900 and the Standard Statistics Bureau in 1906 and Fitch in 1913 had been publishing financial information and updates primarily on US railroad industry.[27]Poor's Publishing and Standard Statistics merged in 1941 to form S&P in 1941, which was acquired by McGraw-Hill Co. in 1966.[28] The Fitch Publishing Company started offering letter based ratings in 1924.[29] While other credit rating agencies were established, such as Duff & Phelps and Thomson BankWatch, they merged into one of the main three: Moody's, S&P, and

[21] See Guide to Credit Rating, supra note 7.
[22] Basel Committee 2000 supra note 6 p. 12.
[23] Ibid.
[24]*Report: Watchdog* supra note 8 p. 77.
[25] "Moody's History: A Century of Market Leadership," https://www.moodys.com/Pages/atc001.aspx
[26] Ibid.
[27] John Moody & Company published Moody's Manual of Industrial and Miscellaneous Securities in 1900, ibid. See also "A History of Standard & Poor's," Standard & Poor's, http://www.standardandpoors.com/about-sp/timeline/en/us/; and "Our Organization", Fitch, http://www.fitchratings.com/web/en/dynamic/about-us/about-us.jsp.
[28] See Richard Cantor & Frank Packer, "The Credit Rating Industry," (1994) *Federal Reserve Bank of New York Quarterly Review*, p. 2.
[29] Ibid.

Fitch,[30] the three ratings agencies first recognized by the US Securities and Exchange Commission (SEC) as a nationally recognized statistical rating organization (NRSRO) in 1975. The rating activities of credit rating agencies were not solely restricted to the US, but had expanded to Europe and other countries[31].

Over the last few decades, the rating industry has witnessed exponential growth and their role as independent 'watchdog' and 'gatekeeper' of the financial market stands well established globally. Moody's Corp., the parent company of Moody's Investors Service and the largest of the three, has reported revenue of $2.7 billion in 2012, maintains a presence in 29 countries[32]. One of the reasons that influenced the growth is the unchallenged reputational capital accumulated over decades[33].The agencies generally getting their risk assessment right. An AAA has a less than 1 percent default rate over 10 years or more[34] while bonds rated BB+, B and CCC have an approximately 20 percent, 35 percent 55 percent default rate over 15 years period[35].S&P claims that of all corporate sector "investment grade" ratings issued, only 1 percent has defaulted over the most recent five-year period[36]. The infallibility of the rating agencies hadmade consumers and investors blindly rely on their rating while making investment decisions.

However, the driving force behind the success and influence of rating industry should be attributed to the oligopolistic nature of the industry operating in an unregulated environment, complimented by the regulatory recognition of credit ratings in the financial regulations[37]. The national regulators heavily relayed on ratings in calculating the risk exposure and capital adequacy requirements. he regulators insisted on using third party credit ratings, with explicit recognition of

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[30] Report: Watchdog, supra note 8 p. 77. Fitch Ratings Ltd. merged with IBCA of London and subsequently acquired. Josh Wolfson and Corinne Crawford "Lessons From The Current Financial Crisis: Should Credit Rating Agencies Be Re-Structured?" (2010) 8 (7) *Journal of Business & Economics Research* p. 85.

[31]"Analytical Leadership in Europe" https://www.moodys.com/pages/default_em.aspx. Moody's for instance was rating the European issuers of debt obligations since 1920. However, the first Europe office was opened by S&D only in 1984. Tokyo office was opened in 1986. "A History of the Standard & Poor's", http://www.standardandpoors.com/about-sp/timeline/en/us/

[32]The firm's ratings and analysis track debt covering more than 115 countries, 10,000 corporate issuers, 22,000 public finance issuers, and 82,000 structured finance obligations. See "Moody's Role in the Capital Markets," https://www.moodys.com/Pages/atc.aspx. See also Crawford &Wolfson, supra note 31 at 85.

[33] 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 COLUM. BUS. L. REV. 109, 113 (2009). See also *Role and Function of Credit Rating Agencies* 2002 supra note 3.

[34]*Rating the Raters* 2002 supra note 1 at 63-64.

[35]Ibid p. 64.

[36]"Our Track Record, S&P", https://ratings.standardandpoors.com/about/who-we-are. See also Leo Brand and Reza Bahar, "Corporate Defaults: Will Things Get Worse Before They Get Better" *S&P CreditWeek*, January 31, 2001, pp. 15, 27.

[37] Kenneth C. Kettering, "Securitization and Its Discontents: The Dynamics of Financial Product Development" 29 (2008) *Cardozo Law Review* p. 1674.

selected credit rating agencies by some regulators in some jurisdictions[38]. Thus, the national regulators have outsourced to CRAs much of the responsibility for assessing debt risk or benchmarked the rating agencies' assessment as proxy for regulator's assessment, thereby making the CRAs *de facto* regulators in the financial market[39].

The US, for instance, has recognized credit rating for regulatory purposes since the 1930s[40]. About eight US Federal statutes and 47 federal regulations, along with over 100 State laws and regulations have reference to rating as a benchmark[41]. The practice of regulatory "hard wiring' of rating is liberally practiced across jurisdictions and by international standard setting bodies[42]. The international banking norms set by the Committee on Banking Supervision has placed enormous emphasis on credit ratings in the determination of overall capital for banking institutions[43]. The Basel II norms are incorporated by federal/central banks into the domestic regulations of most states[44].

With a credit rating effectively required by law for so many purposes, issuers in most instances sought the ratings out of necessity[45]. The international consensus on the mandatory use of ratingstransformed the rating agencies into a highly influential force in the financial system, yielding considerable power to determine who is complying with regulatory. This privileged market position

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[38] Basel Committee 2000, supra note 5 p. 1.

[39]Elkhoury, supra note 16, p. 2.

[40] See 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.

[41] In 1975, the SEC significantly enhanced the importance of credit ratings to assure investors that their broker-dealers have sufficient assets to back up the funds that investors entrust them with.*Report: Watchdog*, supra note 8 p. 77. See also Frank Partnoy, "The Siskel and Ebert of Financial Markets: Two Thumbs Down For the Credit Rating Agencies" (1999) 77 *Wash. U. L.Q.* p. 687. See also Steven L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox" (2002) 1 *University of Illinois Law Review* 1-28.

[42] The Australian Prudential Regulation Authority (APRA) recognizes mortgage insurance by insurers that have a rating of A or higher by a recognized rating agency and ratings have a role in determining the adequacy of credit enhancements provided to securitization schemes. See APRA, *Guidelines on Recognition of an External Credit Assessment Institution* (2008) 12–13). In Hong Kong, ratings are used to determine what is a liquefiable asset in the liquidity regime. In Argentina and New Zealand, the authorities make use of agencies' ratings of the banks in their regulation. They are used to provide information to the banks' creditors and thereby facilitate market discipline. In France the 1991 obligates issuers of certain securities to obtain a rating before they may issue their securities. Law No.91-715 of July 26, 1991, *Journal Officiel de la R PubliqueFranraise* at 9952 in Carsten Thomas Ebenroth and Thomas J. Dillon, JR "The International Rating Game: An Analysis of the Liability of Rating Agencies in Europe, England, and the United States" 24 *Law &Pol'y. Int'l. Bus.* 783 1992-1993 p. 787

[43]See also *Basel Committee* 2000 supra note 5 p. 14.

[44] Patrick Van Roy, "Credit Ratings and the Standardized Approach to Credit Risk in Basel II", *ECB Working Paper Series No.* 517, August 2005, p. 7. As per the Financial Stability Institute (FSI), 95 national regulators indicated they were to implement Basel II, in some form or another, by 2015. See FSI, "Implementation of the new capital adequacy framework in non-Basel Committee member countries: Summary of responses to the 2006 follow-up Questionnaire on Basel II implementation" September 2006. http://www.bis.org/fsi/fsipapers06.htm. See also M. Jayadev, "Basel III implementation: Issues and challenges for Indian banks," (2013) 25 *IIMB Management Review*115-130.

[45] Report: Watchdog, supra note 8 p. 83

was further complemented in the US by the oligopoly created by the non-transparent NRSRO designation adopted by the SEC's since the 1970s dissuading competitors from entering the market[46].Though several efforts were made to increased competition within the rating industry, the SEC has been reluctant in granting additional recognitions[47]. The SEC thus cemented the market dominant position of the "big three"- S&P, Moody's, and Fitch[48]. These three rating agencies today rate practically all of the public corporate debt obligations in the US and across the globe.

II.3 Role of CRAs in the current financial crisis

The global financial crisis was not the first time that the role of rating agencies has come under criticism and scrutiny. The rating agencies have been generally criticized for their questionable revenue model and because of the liberal legal environment and unchecked role[49]. The US Congress took some serious note of their functioning only in the aftermath of the bankruptcies of Enron, WorldCom, and Parmalat. The rating agencies had in these cases maintained highest ratings until just before their collapse and ultimate bankruptcy[50]. The US regulatory interventions,however, were minimalist, and the core functioning of the rating agencies remained largely untouched[51]. It was only after the sub-prime crisis and the sovereign debt crisis that fundamental modifications ensued.

In the investigations that followed,rating agencies were implicated as the key enablers of the financial meltdown[52]. The rating agencies were found to have misused their role and influence over the global financial market in the context of rating structured financial products and sovereign rating downgrades. The 2011US National Commission on the Financial Crisis concluded that:

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[46] Catherine Lubochinsky and Olivier Raingeard, "Comments on the Proposal for a Directive/Regulation of the European Parliament and of the Council on Credit Rating Agencies" Submission to the EC, *Consultation on Policy Proposals regarding Credit Rating Agencies*, 5 September 2008, p. 8–9.

[47] Since 1990's, Congressman John Dingell wrote a number of letters to the SEC calling for and a setting of national standards for NRSROs. See Report: Watchdog, supra note 8 p. 80. The SEC has qualified only ten NRSROs and denied applications from 130 other rating agencies, Crawford and Wolfson, supra note 32, p. 87.

[48] Frank Partnoy, "How and Why Credit Rating Agencies are not Like Other Gatekeepers" *Univ. of San Diego Sch. of Law* Research Paper No. 07–46, 2006, pp. 62–68 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=900257.

[49] Harry McVea, "Regulating credit rating agencies in the European Union: where might it lead?" (2010) 83 *Amicus Curie* p. 2.

[50]Less respect for credit rating agencies, *The Japan Times*, February 6, 2012.In 2007, as housing prices began to tumble, Moody's downgraded 83 percent of the $869 billion in mortgage securities it had rated at the AAA level in 2006.

[51] The Credit Rating Agency Reform Act of 2006 formalized the registration process for NRSRO and introduced measures designed to improve the conditions for competition, procedural transparency and operational oversight. Tin A Bunjevac, **"**Credit Rating Agencies: A Regulatory Challenge for Australia" (2009) 33*Melbourne University Law Review* p. 47.

[52] See generally, US Senate Permanent Subcommittee on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse; Majority and Minority Staff Report* (Permanent Subcommittee on Investigations, Washington, DC April 2011).

> …the failures of credit rating agencies were essential cogs in the wheel of financial destruction. The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were obligated to use them, or regulatory capital standards were hinged on them. *This crisis could not have happened without the rating agencies.* Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms.[53]

The findings were supported in several studies that the ratings of structured financial products were indeed highly inflated[54]. These inaccurate ratings contributed significantly to the financial crisis by mismanagement of risk by financial institutions and investors and hiding the true risk of many mortgage-related securities. The rating agencies, for instance, issued AAA credit ratings for thousands of US residential mortgage backed securities (RMBS) and collateralized debt obligations (CDO) despite their risky features[55]. Over 90 percent of the AAA ratings given to RMBS securities were later downgraded to junk status. Further the rating agencies chose to ignore the low quality of the loans being securitized and the prevalence of fraud in the mortgage industry[56].

The rating agencies knowingly overrate such structured products because of the high level of profit margins and to attract business. The agencies considered these financial products as "cash cows," very lucrative and important source of business, when compared to traditional bonds[57]. In 2006, structured finance product accounted for 44 percent of Moody's business, while traditional corporate finance accounted for just 32 percent[58]. In 2008, there were as many as 64000 structured finance instruments rated AAA while there were only 12 triple A-rated companies across the world[59]. In one of the private messages recorded as evidence in *Abu Dhabi Commercial Bank case,* one of the analysts declaring that Cheyne SIV "could be structured by cows and we would rate it"[60]. The rating agencies and the issuers engaged in "rating shopping"[61] meaning, if a given rating agency did not

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[53] US, The Financial Crisis Enquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, The Financial Crisis Inquiry Commission Pursuant to Public Law 111-21, January 2011 http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf

[54] Ibid.

[55] US Senate: Wall Street and the Financial Crisis 2011 supra note 54.

[56] Ibid, p. 272.

[57] See *Abu Dhabi Commercial Bank, et al vs. Morgan Stanley & co. et al* US District Court Southern District of New York, Opinion and Order,08 civ. 7508 (SAS) August 17, 2012 p. 50

[58] Joshua D. Coval et al., "The Economics of Structured Finance" 3–4, *Harv. Bus. Sch. Fin. Working Paper No*. 09-060, Oct. 20, 2008, available at http://ssrn.com/abstract=1287363.

[59] Amicus Curie, supra note 50, p. 4.

[60] *Abu Dhabi Commercial Bank,* supra note 13, p. 41.

[61] Jerome S Fons, 'Rating Competition and Structured Finance' (2008) 14(3) *Journal of Structured Finance,* p. 11.

issue top ratings, for say, desired by Morgan Stanley, they could take business elsewhere[62]. Thus, regardless of whether those ratings were supportable or not, rating agencies had incentives to issue top ratings.

In the European context of sovereign debt crisis, the rating agencies were faulted for mistakenly downgrading states, and in turn, plunging financial markets into a state of profound distress[63]. Downgrade to below investment-grade threshold often triggers immediate liquidation, leading to herd behavior. This "may increase market volatility and may even cause a self-sustaining downward spiral of asset prices with potential negative effects for financial stability"[64]. Because of the spillover effect, the sovereign rating downgrades impact not only the financial markets in the country subject to the downgrade but also other euro area countries[65]. Moreover, the sovereign downgrades not only adversely affect the concerned State but also its financial system and market players as a whole.

III. Regulatory Responses of States: National and International

Having formally incriminated the rating agencies for their role in accelerating the financial debacle, efforts turned towards fixing the problem. States in general called for a strong regulatory mechanism with a two-pronged strategy: to reduce regulatory reliance on ratings, and regulate the CRAs directly[66]. Specifically, the proposed regulatory framework attempts to (i) increasing scrutiny of rating agencies conduct and methodologies (ii) increase rating agencies accountability for ratings, (iii) reducing reliance on credit ratings, (iv) corporate governance and reducing conflict of interest and (v) provide institutional mechanism to supervise rating agencies. Thus, there is a paradigm shift in state's approach towards rating agencies, i.e., from relative absence of laws to that of aplenty. This section shall analyze the regulatory response, with focus on the collective response at the international level, the EU region and in the US.

III.1 International response and action plan

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[62] See 7/12/04 Letter from Brian M. Clarkson, Executive Vice President of Moody's, to Jonathan G. Katz, Secretary of the SEC, Ex. 588 at MDYS ADCB 1261874, see *Abu Dhabi Commercial Bank* ibid 49.

[63] Petit, 2011 supra note 5 p. 588

[64] European Commission, Public Consultation on Credit Rating Agencies, 5 November 2010. Available at http://ec.europa.eu/internal_market/consultations/docs/2010/cra/cpaper_en.pdf in J de Haan and F Amtenbrink, "Credit Rating Agencies", De Nederlandsche Bank, Working Paper No 278 (January 2011), p. 6.

[65]RabahArezki, Bertrand Candelon and Amadou N. R. Sy "Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis" *IMF Working Paper*WP/11/68, 2011, p. 5 http://www.imf.org/external/pubs/ft/wp/2011/wp1168.pdf

[66]"The Uses and Abuses of Sovereign Credit Ratings" *IMF Global Financial Stability Report* (October 2010) p. 91.

In the aftermath of the global financial crisis, the Leaders of the Group of Twenty (G20)[67]resolved for a “strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct”[68]. The 2008 Washington Summit “plan of action” called for ensuring that CRAs “meet the highest standards … and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products”[69]. The G20 Summit of 2009 agreed to establish a regulatory oversight regime consistent with the IOSCO Code of Conduct[70]. The members agreed that the CRAs should differentiate ratings for structured financial products, provide full disclosure of their rating track record and the information and assumptions that underpin the ratings process. The Basel Committee on Banking Supervision (BCBS) was instructed to review the role of external ratings in prudential regulation[71].

The G20 action plan was put in motion by the Financial Stability Board (FSB), BCBS, IOSCO and by the national regulators. The FSB in 2010 came up with the Principles for Reducing Reliance on Credit Rating Agency Ratings in standards, law and regulation[72]. The Principles call on authorities to remove or replace references to credit ratings in laws and regulations, *wherever possible*, with suitable alternative standards of creditworthiness assessment; and recommend banks, market participants and institutional investors make their own credit assessments, and not rely solely or mechanically on CRA ratings[73]. The Principle attempts to minimize “hard wiring” of CRA ratings[74] and reduce herd behavior and abrupt sell-offs of securities when they are downgraded (cliff effects) from CRA ratings that can amplify procyclicality and cause systemic disruption[75]. The peer review mechanism established by the FSB to review implementation of the Principles in their

[67]The Group of Twenty (G20) established in 1999 is the premier forum for international cooperation on the most important issues of the global economic and financial agenda. The G20 brings together finance ministers and central bank governors from 19 countries. See “What is the G20” http://www.g20.org/docs/about/about_G20.html.

[68]Declaration of the Summit on Financial Markets and the World Economy including the Action Plan to Implement Principles for Reform, G20 Special Leader’s Summit on the Financial Situation, Washington DC, November 15, 2008.

[69] Ibid.

[70]Declaration on Strengthening the Financial System London Summit, 2 April 2009. See also The G-20 Toronto Summit Declaration, June 26–27, 2010, para 26.

[71] Ibid.

[72]FSB Principles for Reducing Reliance on CRA Ratings 27 October 2010. The Principles got approval in the G20 Seoul Summit, November 2010.http://www.financialstabilityboard.org/publications/r_101027.pdf.

[73]ibid. See also “Thematic Review on FSB Principles for Reducing Reliance on Credit Rating Agency Ratings,” Interim Report 29 August 2013, p. 3 http://www.financialstabilityboard.org/publications/r_130829e.pdf

[74] Principle I, FSB Principles for Reducing Reliance on CRA Ratings 27 October 2010, http://www.financialstabilityboard.org/publications/r_101027.pdf

[75] FSB, Thematic peer review on the FSB Principles for Reducing Reliance on Credit Rating Agency (CRA) Ratings Questionnaire, 28 March 2013, p. 1 http://www.financialstabilityboard.org/publications/r_130408.pdf.

firstinterim report has found that the US and the EU has made considerable progress in removing hard-wiring of ratings, while other jurisdictions lag behind[76].

Credit rating figure prominently in international banking norms set under the Basel II framework which serves as the foundation for the use of credit ratings in national regulations[77]. It was the over reliance by banks on rating agencies risk assessments in the securitization field which proved to be wrong, ultimately led to financial instability. In compliance with the G20 and FSB objectives, the Basel Committee is reviewing such reliance in Basel III securitization framework, where such reliance is predominant. The proposal shall be put in place by mid-2014, however, identifying alternative standards of creditworthiness remains a challenge[78].

The IOSCO, a global standard setter for securities regulation, has adopted self-regulatory CRA Principles (2003) and Code of Conduct (2004)[79]. The Principles are meant to be "used by CRAs of all types and sizes, using all types of methodologies, and operating under a wide variety of legal and market environments", whereas, the Code describes in more detail how the Principles might be applied in practice. The Principle and the Code ensures that a converged standard of CRA conduct exist throughout the world, irrespective of market circumstances and legal and regulatory structures[80]. Any deviation or departure from the Code only needs to be disclosed under the "comply or explain" system of self-regulation (in EU).[81] The Committee of European Securities Regulators (CESR) have found that "non-compliance, …, indicates that some of the issues which the IOSCO Codeis intended to address, are not being managed through the CRAs Codes in a manner that matches the IOSCO Codeprovisions exactly"[82].

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[76]For instance, China, Indonesia and South Korea have made little progress in dealing with concerns about over-reliance on credit rating agencies. Final report is due in 2014. Ibid.
[77]Ibid. See also Credit Ratings and Complementary Sources of Credit Quality Information Basel Committee on Banking Supervision Basel BCBS Working Papers No 3 July 2000, p. 1. Basel Committee on Banking Supervision, The Joint Forum Stocktaking on the use of credit ratings, Bank for International Settlement, June 2009, p. 3. http://www.bis.org/publ/joint22.pdf. Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, See http://www.fsforum.org/publications/r_0804.pdf.
[78] Ibid.
[79] IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies and Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO Technical Committee, December 2004, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf.
[80]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(2008).
[81] John C. Coffee, "Ratings Reform: The Good, The Bad, and The Ugly" 249 (Sept. 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1650802.
[82] FSB Thematic Review Interim Report, supra note 75.

The Code was reviewed in the wake of subprime crisis and suitability amended to address the questionable role played by the CRAs in the structured finance market[83]. The amendments address the issue of quality and integrity of the rating process, their independence and conflict of interest, responsibilities to the investing public and issuers, and disclosure requirements[84]. Further, in 2009, the IOSCO established a Task Force on Credit Rating Agencies to review and update the international regulatory consensus regarding CRA oversight; and serving as a forum for regular interaction between regulators and CRAs[85]. In addition, the IOSCO has recently recommended the establishment of a "supervisory colleges" for internationally active CRAs to inter alia supervise their compliance with local or regional laws and regulations[86]. In compliance with the G20 mandate, the IOSCO Code has been incorporated into national laws ensuring their universal recognition across jurisdictions.

III.2 Regional/National Responses

The US and the Europe have taken the lead in the regulatory response against rating agencies. Both regions have made sweeping changes in their internal laws opted for a strong supervisory regime, ending the golden period of an unregulated market conditions for rating agencies. The US Congress initial attempt to regulate rating agencies was the Credit Rating Agency Reform Act of 2006 in the aftermath of the Enron debacles[87]. Though the Act was adopted after several investigations, including at least nine separate Congressional hearings and a major Congressional staff report, the Act failed to have any major impact[88]. The major regulatory overhauled followed the post subprime and financial crisis in 2010 through the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[89].

[83] Final Report on the Role of Credit Rating Agencies in Structured Finance Markets, Technical Committee of the International Organization of Securities Commissions May 2008, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf

[84] "IOSCO to implement changes to Code of Conduct for Credit Rating Agencies", Media Release, IOSCO/MR/006/2008, Paris, 28 May 2013, http://www.iosco.org/news/pdf/IOSCONEWS120.pdf.

[85] IOSCO "Update on Credit Rating Agencies Oversight," Media Release, IOSCO/MR/04/2009, 12 March 2009.

[86] IOSCO "Publishes Recommendations for Supervisory Colleges for CRAs," Media Release, IOSCO/MR/28/2013, 30 July 2013.

[87] Kettering 2008 supra note 38 p. 1674. See also Section 702 of the Sarbanes-Oxley Act of 2002 directs the SEC to conduct a study of the role and function of credit rating agencies in the operation of the securities market. See Claire A. Hill "Rating Agencies Behaving Badly: The Case of Enron" (2003) 35 *Conn. L. Rev.* 1145-1146.

[88] See Watchdogs Report supra note 8, and Staff of the S. Comm. on Governmental Affairs, 107th Cong., Report: Enron's Credit Rating: Enron's Bankers' Contacts with Moody's and Government officials (Comm. Print Jan. 2, 2003).

[89] Pub.L. 111–203, H.R. 4173 signed into law by the President on 21 July 2010.

The Dodd-Frank Act 2010, it has been said, brought aboutin the most significant changes to the US financial regulations since the great depression[90]. Under the Act, the rating agencies practically entered into an entirely new regime of regulation, comprehensively amending Section 15E of the Securities Exchange Act of 1934[91].The Act reasoned a strong regulatory intervention on the basis that rating agencies play a central role in capital formation, investor confidence, and public interest[92]. The Act justified that since the CRAs are fundamentally commercial in character, performing a function similar to that of auditors, securities analysts, and investment bankers, they should be subject to the same standards of liability and public oversight[93]. TheActadds a number of requirements on CRAs that will have immediate effect and authorized the SEC to adopt a number of new rules. Most rules are yet to be framed[94].

In Europe, the approach until the sovereign debt crisis has been that any legislative intervention is needed only “if it becomes clear that compliance with EU rules or the IOSCO Code is unsatisfactory and damaging EU capital markets”[95]. So the rating agencies remained largely self-regulated under the IOSCO Code[96]. It was only at the end of 2008 that the EC finally decided to regulate CRAs[97] and adopted Regulation (EC) No 1060/2009 on CRA[98]. The Regulation was part of

[90]The Act has more than 2,300 pages in length, directs regulators to create 533 new rules. The Act also creates a new consumer financial protection bureau with the power to create and enforce new rules regarding financial products like home-equity loans and credit cards. Annie Lowrey, “Obama to Sign Dodd–Frank Financial Regulatory Reform Bill into Law Today” *The Washington Independent* July 21, 2010. Damian Paletta and Aaron Lucchetti, “Senate Passes Sweeping Finance Overhaul” *Wall Street Journal*, July 16, 2010.
[91]Paletta and Lucchetti, Ibid.
[92]Sec. 931, Dodd-Frank Act 2010.
[93]Sec 931 (2) and (3), Dodd-Frank Act.
[94] The SEC must make new rules concerning: Annual reports on internal controls, conflicts of interest with respect to sales and marketing practices, “Look-backs” when credit analysts leave the NRSRO, Fines and penalties, Disclosure of performance statistics, Application and disclosure of credit rating methodologies, Form disclosure of data and assumptions underlying credit ratings. See “Credit Rating Agencies” http://www.sec.gov/spotlight/dodd-frank/creditratingagencies.shtml
[95]European Parliament Resolution on Role and Methods of Rating Agencies, 2004 O.J. (C 97 E) 117. In 2002, the EC had mandated the ECOFIN to analyze the issue of CRAs. In 2004, the European Parliament adopted a resolution on role and methods of rating agencies. See Communication from the Commission on Credit Rating Agencies, 2006 O.J. (C 59) 2, in Alexia Manaigo-Vekil “The Regulation of Credit Rating Agencies in Europe and ESMA'S Supervisory Power” (2012) 18 *Col. J. Eur. L. Online* 34. See also Resolution by the German Federal Parliament on improving the integrity, independence and transparency of rating agencies through a code of conduct (March 2004).
[96] See Coffee, supra note 81. France is one country where there was some mechanism in place. Article 3 of the Decree No. 92-137 of1992 requires the issuers who must receive ratings on their securities to obtain them only from those rating agencies approved by the French Finance Minister before they may issue the securities. See Ebenroth and Dillon, supra note 42.
[97] Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies at 2, COM (2008) 704 final (Nov. 12, 2008).
[98] Regulation (EC) No. 1060/2009 on Credit Rating Agencies, *Official Journal of the European Union* L 302/1, Edn. 302, November 2009.

Europe's commitments made at the G20 Summit in 2008[99]. The new rules aim to create a common framework for registration, conduct of business and supervision of CRAs. The regulation aims to reduce reliance on credit ratings, improve the transparency of sovereign debt, introduce a civil liability regime, enhance diversity in the rating industry and address conflicts of interests due to the issuer's pays model. The Regulation was further amended in May 2011 and May 2013 to create the European Securities and Markets Authority (ESMA) and further reinforce the regulatory framework and deal with outstanding weaknesses[100].

Similar efforts to regulate the functioning of CRAs was made or proposed in other national jurisdictions. Most jurisdictions have taken wait and watch policy considering the development in the US and the Europe. Japan in 2009, introduced a new regulatory framework for CRAs[101]. The new framework requires a credit rating agency to be registered with the Financial Services Agency of Japan (JFSA) in order for its ratings to be used for regulatory purposes in Japan. The JFSA has powers to take a number of measures, including sanctions, against CRAs for breach of the provisions of the Financial Instruments and Exchange Act 2006.

The section below shall consider in specific detail some of the major regulatory interventions and changes adopted by the EU and the US.

III.2.i Institutional arrangement for Supervision and implementation

The foremost step taken by the State in CRAs governance was the establishment of a dedicated institutional framework for recognition, registration and supervision of CRAs. The US Congress created the Office of Credit Ratings (OCR) within the SEC with a mandate to administer the SEC's rules relating to NRSROs[102]. As the executive arm, OCR supports the SEC's mission to protect investors, facilitate capital formation, and maintain fair, orderly, and efficient markets. In particular, the Office shall monitor practices of NRSROs in determining credit ratings, promoting

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[99] See Declaration of the Summit on Financial Markets and the World Economy, Washington DC, November 15, 2008.

[100]Regulation 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies, 56 *Official Journal of the European Union*, 31 May 2013. Entered into force on 20 June 2013. Directive 2013/36/EU of The European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC, *Official Journal of the European Union* L 176/338, 27 June 2013

[101]The December 2009 Cabinet Orders and Cabinet Office Ordinances laid out the details of the terms and conditions of this framework which became effective in April 2010.

[102]See “About the Office of Credit Ratings” http://www.sec.gov/about/offices/ocr/ocr-about.shtml.

accuracy in credit ratings issued by NRSROs, ensuring that credit ratings are not unduly influenced by conflicts of interest, and helping to ensure that firms provide greater disclosure to investors[103].

Similarly, in Europe, ESMA was established in 2011 for CRA's registration, supervision and monitoring of compliance with CRA Regulation[104].ESMA is part of the European System of Financial Supervision which consists of the European Systemic Risk Board (ESRB) and the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA). ESMA centralizes and simplifies the supervision of CRAs at European level[105]. ESMA could initiate actions ranging from the issuance of a public notice or withdrawal of the registration, to request the SEC to impose on a CRA a fine, where the CRA has intentionally or negligently committed a breach of the Regulation. The EC shall review the situation in the credit rating market by July 2016, and shall consider the need and feasibility of establishing a European Credit Rating Agency for Member States' sovereign debt and/or a European credit rating foundation for all other credit ratings[106].

III.2.ii Eliminating "hardwiring" and reducing reliance on credit ratings

One of the issues recognised by the lawmakers across the globe was the problem of mechanical and blind reliance on rating without understanding or verifying the authenticity or basis of such ratings. The attempt to remove or minimize reliance on external rating has been addressed at two levels: firstly, by removing or replacing references to CRA ratings in laws and regulations and secondly, by strengthening internal creditworthiness assessment. The US regulatory approach is towards total removal of all reference to ratings in laws and regulations. The US Dodd-Frank Act mandates the federal agencies to review existing regulations for removingrating references from their

[103] Ibid.

[104]Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (ESMA), amending Decision No 716/2009/EC. CRAs are at present the only financial institutions which are directly supervised by a European Supervisory Authority.

[105] The pre-amended EC Regulation on CRAs had left the responsibility of supervision and action on breach of the regulations on the home Member State which was given the power to withdraw the registration or temporarily prohibit or suspend the issuing of or use of credit rating and can refer for criminal prosecution to its relevant national authorities. See Article 24, EU CRA Regulation.

[106]Article 39b, EU CRA Regulation - Reporting obligations. The U.K. expressed strong opposition on issuance of credit ratings by a public European Credit Rating Agency, Central Banks, or a public-private partnership. "UK Authorities Oppose European Public Credit Rating Agency", Tuesday, 18th January 2011 http://www.automatedtrader.net/real-time-dow-jones/41353/uk-authorities-oppose-european-public-credit-rating-agency#sthash.CmYTuJvL.dpuf .

rules as appropriate[107]. Similarly, SEC is also exploring ways to reduce regulatory reliance on external credit ratings and replace them with alternative criteria[108].

The EU, on the other hand, approaches the total removal with caution and only mandates reducing regulatory hardwiring[109]. Emphasis is placed on strengthening internal credit risk assessment, with external ratings only to compliment them. External credit ratings must be used only to the extent necessary and "competent authorities shall … monitor that they do not solely or mechanistically rely on external credit ratings for assessing the creditworthiness of an entity or financial instrument"[110]. For EU, external ratings still remain the best available alternative and do not consider wise to eliminate external rating altogether without having workable alternatives in places. The systems necessary to produce internal ratings are also costly to implement and supervise. The EC may go the US way once a credible alternative such as an EU public rating agencies, are put in place[111].

III.2.iii Increasing scrutiny of rating agencies conduct and methodologies

The concern over lack of clear and transparent methodology (models and key rating assumptions) has been addressed through elaborate provisions on disclosure. In the US, the SEC is given the onus of prescribing rules with respect to the procedures and methodologies, including qualitative and quantitative data and models that are to be used[112]. Self-disclosure assumptions underlying the credit rating procedures and methodologies, data that was relied on while rating, the potential limitations of the credit ratings, and the types of risks excluded and information on the

[107]Sec. 939, Dodd-Frank Act Removal of statutory references to credit ratings.Some references have already been replaced in US legislation. See "Credit Rating Agencies", http://www.sec.gov/spotlight/dodd-frank/creditratingagencies.shtml

[108]Sec. 939A, Dodd-Frank Act - Review of reliance on ratings.

[109] Para 70, Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013.

[110]Ibid.The Article 77, Dodd-Frank Act - Internal Approaches for calculating own funds requirements. See also Article 161, Review and report. The Directive amends current directives on the activities and supervision of institutions for occupational retirement provision (IORP) (Directive 203/41/EC) undertakings of collective investment in transferable securities (UCITS) (Directive 2009/65/EC)and on alternative investment funds managers (AIFM) (Directive 2011/61/EU) in order to reduce these funds' reliance on external credit ratings when assessing the creditworthiness of their assets.

[111] According to the Regulation CRA III (MEMO/13/571), by 31 December 2015, the EC shall submit a report to the European Parliament and to the Council on: (a) the steps taken as regards the deletion of references to credit ratings which trigger or have the potential to trigger sole or mechanistic reliance thereon; and (b) alternative tools to enable investors to make their own credit risk assessment of issuers and of financial instruments, with a view to deleting all references to credit ratings in Union law for regulatory purposes by 1 January 2020, subject to appropriate alternatives being identified and implemented. EC MEMO, Capital Requirements - CRD IV/CRR – Frequently Asked Questions, Brussels, 16 July 2013.

[112]Sec. 932.Dodd-Frank Act - Enhanced Regulation, Accountability, and Transparency of NSRO.

uncertainty of the credit rating must be made[113]. The rating agencies must consider independent information if they find it credible[114].

The EU also calls for similar disclosure of the rating methodologies, models and key rating assumptions used in credit rating activities[115]. CRAs must use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing[116]. Any change in rating methodologies must be in consultation with issuers, investors and the ESMA. Fully disclose and update on ratings shall be provided to the public,[117] in addition to periodic disclosures to the CESR and to the competent authority of the Member States, including publishing a transparency report every year[118].

III.2.iv Rating agencies liability and accountability for ratings

Rating agencies have historically avoided civil liability for their ratings. For the first time both the US and the EU law have incorporated provisions that hold the rating agencies liable to an investor or issuer for intentional infringement or gross negligence. For this purpose, the US has equates the statements made by a credit rating agency in the same manner and to the same extent as statements made by a public accounting firm or a securities analyst under the securities laws[119]. The SEC can deregister an agency for providing bad ratings over time[120]. With regard civil liability issues in EU, the CRA Regulation civil liability rules apply to all type of credit ratings, regardless their nature (solicited or unsolicited). (Covered in detail in section III below).

III.2.v Corporate governance and reducing conflict of interest issues

One of the paradoxes that inflict rating industry is that the agencies are paid by the same entities that benefit from their ratings, and this creates a situation where financial information could be manipulated and not independent[121]. The EU and the US law have taken elaborate measures to address such a conflict of interest induced by 'issuer pays' model. The US law has proposed

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[113]ibid.
[114]Sec. 935.Dodd-Frank Act - Consideration of information from sources other than the issuer in rating decisions.
[115] Article 8, EC CRA Regulations - Methodologies, models and key rating assumptions
[116]Article 8.3, ibid.
[117]Article 11, General and periodic disclosures. Part I of Section E of Annex I lists the matters that needs to disclosed and updated immediately.
[118]Articles 11 and 12, EC CRA Regulations.
[119]Sec. 933. Dodd-Frank Act.
[120] See Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act , U.S. Senate Committee on Banking, Housing & Urban Affairs, http://www.banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf
[121] Kubota, supra note 3, p. 344.

separation of CRA staff that does ratings from sales and marketing team[122]. Rating agencies shall conduct an internal review to determine whether any conflicts of interest of the employee influenced the credit rating[123]. For instance, the rating agencies must disclosure where a person associated with them within the previous five years obtains employment with any obligor, issuer, underwriter, or sponsor of a security or money market instrument for which the organization issued a credit rating during the 12-month period prior to such employment[124].Small rating agencies are excluded from the purview of these requirements[125].

For better corporate management, the US requires at least half the members of rating agencies' board to be independent with no financial stake in credit ratings. The independent members shall serve for a non-renewable period of fiveyears, and their compensation shall not be linked to the business performance of the NRSRO[126]. In the EC, only one-third of the supervisory board must be independent members[127]. Shareholder limitations have been introduced to prevent CRAs to rate their own shareholders and to hold important shareholdings in more than one rating agency. If a shareholder with 5 percent or more of the capital or voting rights of the concerned CRA holds 5 percent or more of a rated entity, the same must be disclosed. The CRA would be prohibited from rating when a shareholding is 10 percent or more of the capital or voting rights[128]. Ownership of 5 percent or more of the capital or the voting rights in more than one CRA is prohibited, unless the agencies concerned belong to the same group (cross-shareholding)[129].

In addition, Europe has introduced a unique system of mandatory rotation forcing issuers of a specific segment of structured finance instruments (re-securitisations), who pay CRAs for their ratings, to switch to a different agency every four years[130]. An outgoing CRA will not be allowed to rate re-securitised products of the same issuer for a period equal to the duration of the expired contract, though not exceeding four years. Mandatory rotation is not applied to smaller and new credit rating agencies. The issuer should consider the possibility to mandate at least one credit rating agency which does not have more than 10 % of the total market share (on a 'comply or explain'

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[122]Sec 932 (4) Dodd-Frank Act.
[123] Ibid.
[124] For senior and employees directly connected with rating, the NRSRO is mandated to report to the Commission
[125]Sec 932 (4) Dodd-Frank Act.
[126]Sec 932, Dodd-Frank Act.
[127] Article 6, Annex I.A and B details the necessary steps that need to be taken by CRAs to avoid conflict of interest.
[128]Article 6a, Conflicts of interest concerning investments in credit rating agencies.
[129] Rating analyst employed by a CRA should not rate an entity in which he/she has an ownership interest etc. Article 7, Rating analysts, employees and other persons involved in the issuing of credit ratings
[130] Article 6b.1, Maximum duration of the contractual relationship with a credit rating agency

basis)[131] though, it has been warned that forcing to switch between so few rating agencies could push them to use agencies carrying less credibility[132].

III.2.viSovereign ratings

"Sovereign rating" means credit rating where the entity rated or the issuer of the debt or financial obligation is a State or a regional or local authority of a State[133]. The problems with sovereign rating came into the fore only after the rating agencies downgraded EU countries debt which made matters worse for troubling countries. It was alleged that the CRAs reacted to sovereign debt crisis on market mood rather than looking at fundamentals[134]. The call is for stricter regulation of CRAs sovereign ratings as many countries,including France andGermany, feltthat the downgrades have deepened the bloc's fiscal crisis. Michel Barnier, the EU's financial services chief, said that ratings agencies were guilty of "serious mistakes" and shouldn't be allowed to "increase market volatility" through ill-timed or unjustified downgrades[135].

Accordingly, the ECs CRA regulation was amended to improve quality of ratings of sovereign debt, transparency, procedural requirements and the timing of publication[136]. The sovereign ratings shall now be State specific and any statement announcing revision of a group of countries shall be accompanied by individual country reports[137]. Underlying facts and assumptions on each ratingshall be disclosed. Public communications of sovereign ratings, other than credit ratings, rating outlooks, etc, which relate to potential changes in sovereign ratings shall not be based on information that are disclosed without the consent of the rated entity, unless it was available from generally accessible sources or unless there were no legitimate reasons for the rated entity not to give its consent to the disclosure of the information[138].Calendar indicating when the agency will rate States shall be setup. Such publication of unsolicited sovereign ratings is limited to three per year, on

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[131]Article 6b.1, ibid.

[132] "Credit rating rotation diluted by MEPs," 20 June 2012, http://www.euractiv.com/euro-finance/credit-rating-rotation-diluted-m-news-513430

[133] The coverage may also include international financial institution established by two or more States which has the purpose of mobilizing funding and providing financial assistance for the benefit of the members of that international financial institution which are experiencing or threatened by severe financing problems.

[134] See Nikki Tait, "Q&A: Credit rating agencies in spotlight", *Financial Times*, May 7, 2009; and "EU government mist show mettle," *Financial Times*, April 29, 2010.

[135]Jim Brunsden, "Credit Rating Firms in EU to Face Sovereign-Debt Limits", *Bloomberg*Nov 28, 2012.

[136] Para 1, 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.

[137]Article 8a, Sovereign ratings, EU CRA Regulation.

[138]Article 8a.2, ibid.

a Fridays after close of business and at least one hour before the opening of trading venues in the EU[139].

IV.Emerging Liability Regime for Rating Agencies

The liability of rating agencies has been a subject of debate for decades now. Until recently, civil liability for rating agencies was absent from both national and international regulatory framework[140].Thoughthe judicial process has been used in some jurisdictions to attribute liability for false ratings, the outcomes have not been encouraging. Even in the US, the jurisdiction where most claims against rating agencies are filed, the affect parties could seldom establish civil liability under common law cause of actions, including under negligence, deceit, defamation, fraud, etc. Most reported decisions have refused to attributing liability against rating agencies, in the absence of "actual malice"[141]. The rating agencies' have successfully defended the actions by claiming lack of duty to care to an aggrieved investor, no meaningful contractual privity, or that the ratings are merely "opinions" issued in public interest and protected under First Amendment[142]. In short, absent proof of actual malice, the credit rating "opinions" are protected as free speech sanctioning full protection of the courts under First Amendment[143].

In this section, we shall consider the common law and statutory aspects of liability of rating agencies. As the majority of the rating agencies and activities are concentrated in US, most of the claims have been brought to US courts. The primary focus is on US cases, as very few cases exist in other parts of the world[144]. Emerging liability regime post financial crisis shall be considered thereafter.

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[139]Article 8a.4, ibid.

[140] There are few exceptions. Under German law, for a false rating, the right of action lies in its contract with the rating agency. For an investor, a subscription agreement to a magazine published by the rating agency between the investor and the agency is sufficient privity of contract. In the absence of a contract, courts may imply a contract as between investor and rater. See Carsten Thomas Ebenroth& Thomas Daum, *Die rechtlichenAspekte des Ratings von Emittenten und Emissionen,* (1992) 43 *Wertpapiermitteilungen*8 in Ebenroth and Dillon, supra note 42, pp. 788-789.

[141] See generally, Frank Partnoy, How and Why Credit Rating Agencies are Not Like Other Gatekeepers, at 83-89 in YasuyukiFuchita& Robert E. Litan eds., *Financial Gatekeepers: Can They Protect Investors?* (2006); Frank Partnoy, The Paradox of Credit Ratings, at 79 in Richard M. Levich et al. eds. *Ratings, Rating Agencies, and The Global Financial System* (2002); Kenneth C. Kettering, Securitization and Its Discontents: The Dynamics of Financial Product Development, (2008) 29 Cardozo L. Rev. 1553, 1688

[142] Kettering, 2008, p. 1688

[143] See eg, *Computer Corp. v. Moody's Investors Services. Inc* 499 F.3d 520, 529 (6th Cir 2007); *Jafferson County School District v. Moody's Investor's Services, Inc* 175 F.3d 848, 850 (19th Cir 1999).

[144] For instance, in England there have been no cases dealing directly with rating agency liability. See Ebenroth and Dillon, supra note 42, p. 789. However, it has been noted that CRAs are already subject to civil liability in the UK under domestic common law (the tort of negligent misstatement and, in cases where the rating is provided by

VII.1 Judicial approach to rating agencies liability

VII.1.i *Liability of rating agencies in Common law*

Courts in common law jurisdictions have considered the liability of rating agencies, and similar type of activities since the time they started their operation[145]. The contestation was the nature of liability claims that could be brought against the rating agencies for false or inaccurate ratings. The common law actions that were taken recourse to by the investors/subscribers include negligent misrepresentation, fraud, defamation, and breach of contractual obligations. However, depending on the nature of relationship, the cause of action varied. For instance, if the relationship is one defined by contract, it is the contract that will govern the extent and limits on liability. In the early days, rating agencies sold rating information to the general public, whereas, since 1975 they switched to "issuer-pay" model, wherein the ratings are done at the request of the issuers of debt instrument and made availed to the public free of cost. Such contractual relationship may exist in the context of "issuer-pay service" and "private subscription service." In that context, the rating agencies are expected to exercise reasonable decree of care and judgment while rating service is provided. However, this is no regular contractual arrangement; rather, the scope of such a contract is extremely narrow. The agreement is only to publish a credit rating; it did not agree to publish a favorable, nor is there an agreement to publish an acceptable rating[146].

Similarly, in the context of third parties, such as the general public and other investors who have relied on wrongratings for investment decisions, although not in privity with the agency, may claim as intended beneficiaries pursuant to a contract with the issuer[147]. The Rating agencies, thus, may owe a duty of care to investors to give accurate information, and any harm caused by rating issued negligently or knowing to be false or misleading ratings would attract liability for damages[148]. The issue of liability, however, must be addressed in the backdrop of rating agencies' roles as an

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agreement, under contract law). See Explanatory Memorandum to the Credit Rating Agencies (Civil Liability) Regulations 2013 No. 1637, para 7.4. http://www.legislation.gov.uk/uksi/2013/1637/pdfs/uksiem_20131637_en.pdf.

[145] "Note: Liability for Misstatements by Credit-Rating Agencies" (1957) 43 (4) *Virginia Law Review*, pp. 561-575. Note, Protecting the Subjects of Credit Reports, (1971) 80 (5) *The Yale Law Journal* 1035-1069. Charles M. Ullman "Liability of Credit Bureaus after the Fair Credit Reporting Act: The Need for Further Reform" (1971) 17 (1) *Villanova Law Review* 44,45.

[146]See *Compuware Corporation v. Moody's Investment. Services, Inc*. U S Court of Appeals, 499 F.3d 520 (6th Cir. 2007) However, there may be an implied contractual duty to perform contractual obligations "skillfully, carefully, diligently, and in a workmanlike manner." Michigan Supreme Court has recognized that this implied contractual duty "is clearly a form of the traditional negligence standard." *Williams v. Polgar*, 391 Mich. 6, 215 N.W.2d 149, 156 (1974).

[147] Timothy M. Sullivan, *Note: Federal Preemption and the Rating Agencies: Eliminating State Law Liability to Promote Quality Ratings" (2010) 94 *Minnesota Law Review* 2147-2148.

[148]Liability for Misstatements supra note 145.

independent financial market "watchdog" the position that entails considerable public interest entitling for First Amendment protection under the US Constitution.

i. Rating agencies' duty to care

One of the foremost US decisions that laid down the rule on liability against third parties reliance on an incorrect report is *Ultramares Corp. v. Touche*[149]. The case was in the context of the liability of an accountant (auditors) whose certification was relied on by the Plaintiff. In 1924, Ultramares Corp. made loans to accountant's (Touche- the Defendant's) clients (Fred Stern and Co.) after relying on Defendant's financial statements. The Defendant had failed to discover that the company's management had falsified entries to overstate accounts receivable. Defendant's client went bankrupt in 1925, and plaintiff brought a suit seeking the amount of the Stern debt, declaring that a careful audit would have shown Stern to be insolvent. The plaintiff claimed the accountant was liable for negligence. At the appellate stage in the New York Court of Appeals, Judge Cardozo, held that the claim innegligencefailed on the ground that the auditors owed the plaintiff no duty of care, there being no sufficiently proximate relationship:

> To creditors and investors to whom the employer exhibited the certificate, the defendants owed a like duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself. A different question develops when we ask whether they owed a duty to these to make it without negligence. If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants *to a liability in an indeterminate amount for an indeterminate time to an indeterminate class*. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.[150]

In Judge Cardozo's opinion, if such an extension is made, this will "so expand the field of liability for negligent speech as to make it nearly, if not quite, coterminous with that of liability for fraud." Judge Cardozo, however, noted that "even an opinion, especially an opinion by an expert, may be found to be *fraudulentif the grounds supporting it are so flimsy* as to lead to the conclusion that there was no genuine belief back of it." However, negligence alone is not a substitute for fraud"[151]. In sum, a third

[149]*Ultramares Corp. v. Touche*, 174 N.E. 441 (1932).
http://www.eejlaw.com/materials/Ultramares_v_Touche_vT08.pdf
[150]Ibid, p. 4.
[151]Ibid, p. 7. The Court added: "If there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made. In other words, negligence shall not attract liability, but a reckless misstatement or insincere professional opinion may attract liability." at 9.

party, not in privity, may not sue an accountant for damages sustained by negligent reporting, but it may bring suit for damages, if it can prove fraudulent reporting.

In an earlier similar case of credit reporting, *Crist v. Bradstreet,*[152]the plaintiff sued a mercantile agency for defamation in respect of a confidential publication of allegedly false statements to interested subscribers, charging that the credit report was published maliciously in an effort to injure his reputation and credit as a business man. The issue was again, the standard of negligence required to attribute liability. The defendant admitted of disseminating the credit report but denied doing so with malice or intent to injure the plaintiff. The Court of Appeal stated:

> [U]nless the negligence was so reckless as to be equivalent to want of good faith, or amount to evidence of a want of good faith, it was not a matter which would affect the question of liability…Malice is the intent to do an unlawful injury. Negligence in some degree might be evidence of malice, but it is not itself malice[153].

On claims based on defamation, i.e., the reputation of the company has suffered due to erroneous rating, the defense of "qualified" or "conditional privilege" has been invoked to rescue from liability[154]. The defense essentially protects any publisher of a defamatory statement from liability[155]. In *Johns v. Associated Aviation Underwriters* it was said: "A communication made in good faith on any subject, in which the person reporting has an interest and in reference to which has a duty, is conditionally . . . privileged if made to a person having a corresponding interest or duty[156]. The Courts justification was on the ground that the privilege is a *sine qua non* for "frank reporting"[157] and "[w]ithout such protection few would undertake to furnish the information and the cost would be high, if not prohibitive"[158]. The harm that occasionally such defamatory statements may do to Plaintiff is believed to be small in relation to the benefits that subscribers derive from frank reports[159]. However, conditional privilege defense shall not hold in the case of proven malice.

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[152]9 Ohio Dec. Reprint 618 (Super. Ct.) *af'd,* 9 Ohio Dec. Reprint 751 (Super Ct. 1886).
[153]Ibid p. 751.
[154] Lord Atkinson, speaking in the *Adam* case, was of the opinion that: A privileged occasion is . . . an occasion where the person who makes a communication has an interest or duty, legal, social, or moral, to make it to the person to whom it is made, and the person to whom it is so made has a corresponding interest or duty to receive it. This reciprocity is essential. *Adam v. Ward* [1917] A.C. 309 at 334. See also two earlier decisions, *Robinson v. Dun*, 24 Ont. App. 287 (1897); *Todd v. Dun, Wiman& Co.*, 15 Ont. App. 85 (1887).
[155] Charles M. Ullman "Liability of Credit Bureaus after the Fair Credit Reporting Act: The Need for Further Reform" [1971] 17 (1) *Villanova Law Review* 44 at 47.
[156]*Johns v. Associated Aviation Underwriters et al*, 203 F.2d 208 (5th Cir.), cert. denied, 346 U.S. 834 (1953) at para 15.
[157]*Watwood v. Stone's Mercantile Agency,* 194 F.2d 160, 161 (D.C. Cir.), cert. denied, 344 U.S. 821 (1952).
[158]*Shore v. Retailers Commercial Agency*, 342 Mass. 515, 520, 174 N.E.2d 376, 379 (1961) in Ullman supra note 155 p. 51.
[159] Ibid.

In a 1957 case, *H. E. Crawford Co. v. Dun & Bradstreet,*[160]Dun & Bradstreet was furnishing commercial credit ratings and reports to its subscribers. In addition to a compilation of ratings, it furnished reports of individual companies pursuant to contracts each of which contains the provision that all information furnished "shall be held in strict confidence, and shall never be revealed or made accessible in any manner whatever to the persons reported upon or to any others". Dun & Bradstreet committed an error in the August 19, 1953 report which was sent to 43 subscribers. Crawford sued Dun & Bradstreet for the publication of a "false, malicious and defamatory libel," and prayed for general and punitive damages. Dun & Bradstreet pleaded report was a "mistake . . . innocently made without malice or improper purpose," "made in the ordinary course of business and without any ulterior or malicious motive"[161]. The District judge while granting directed verdict held that the report was privileged and that no malice was shown to destroy the qualified privilege of the defendant.

The US Court of Appeals Fourth Circuit, while affirming the above verdict, distinguished "legal malice" which is inferred merely from the falsity of the publication, from "actual malice." "Actual malice means ill will, spite or vengeance, bad motives"[162]. The Court noted that

> In the case of a privileged communication, however, express malice as distinguished from malice in law must be shown; that is to say, if the occasion be privileged, the plaintiff may not recover, although he proves that defendant used language actionable per se, and that same was false, unless he goes further and shows that in using same defendant was moved by actual malice, such as ill will, spite, grudge, or some ulterior motive[163].

Thus, the law was well established – even when a rating is false, in the absence of proof that it was published with actual or express malice, rating agencies are not liable. The burden of proving actual or express malice was so demanding that "the agencies have enjoyed virtual immunity from

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[160]*H. E. Crawford Co. v. Dun & Bradstreet, Inc., 241 F.2d 387,* 393 (4th Cir. 1957). https://bulk.resource.org/courts.gov/c/F2/241/241.F2d.387.7274.html

[161] Ibid.

[162]For instance, actual malice has been defined as "any indirect and wicked motive"; an act done "maliciously or for no good purpose"; an act "governed by a bad motive" (*Stevenson v. Northington*, 1933, 204 N.C. 690, 694, 169 S.E. 622, 624); injury "inflicted in a malicious, wanton, and reckless manner"; conduct "actually malicious or wanton, displaying a spirit of mischief toward the plaintiff, or reckless and criminal indifference to his rights . . ." (*Broadway v. Cope*, 1935, 208 N.C. 85, 89, 90, 179 S.E. 452, 455); a "wrongful, indirect, and ulterior motive" (*Gattis v. Kilgo*, 1901, 128 N.C. 402, 407, 38 S.E. 931, 933). See *H. E. Crawford Co. v. Dun & Bradstreet, Inc.,* ibid.

[163] Ibid.

suit"[164]and has virtually shielded the rating agencies against their susceptibility to indeterminate liability. Liability in negligence for misstatement seems nonexistent[165].

ii. Rating as "opinion"

The rating agencies have met with considerable success in claiming full protection under the defense of "free speech," a US Constitution First Amendment right[166]. The defense is based on the premise that ratings are "opinions" issued in "public interest" and thus deserving protection under free speech. With some exceptions,[167] federal courts have consistently held credit ratings as opinions[168]. The defense has its origin in *N.Y. Times Co. v. Sullivan* case were the Supreme Court excused publishers from liability for defamation claims absent a showing of "actual malice" and reasoned that protection by such a standard for liability was necessary to encourage reporting on matters of public concern[169]. Accordingly, in the absence of "actual malice," the standard of treatment given to media is expected to be applied for rating agencies publishing credit rating for interest of public at large[170].

In *Orange County v. McGraw Hill Companies, Inc.*,[171]the plaintiff entered into a written contract under which S&P agreed to provide credit-rating services for the plaintiff. S&P issued a credit rating stating that the plaintiff's financial condition and ability to repay its debt were

[164] Ullman, supra note 155 p. 52. The defense of condition privilege could also be extent as a defense in violation of privacy where the plaintiff had claimed that the facts disclosed by the bureau were of a private or personal nature, and that the disclosure would have been offensive to a person of ordinary sensibilities. See Ullman, supra note 155 at 57.

[165] "Liability for Misstatements by Credit-Rating Agencies" (1957) 43(4) *Virginia Law Review* p. 574. It has been argued that a duty to care for rating agencies may exist in England on the basis of foreseeability, proximity, and fairness. See Ebenroth and Dillon, supra note 42, p. 799.

[166] Kettering, 2008, p. 1689. The extract of the US Constitution, Amendment I states that "Congress shall make no law . . . abridging the freedom of speech, or of the press; … and to petition the government for a redress of grievances."

[167] The Erie County Supreme Court in *M&T Bank Corp. v. Gemstone CDO VII, Ltd.*, had held that "the ratings by Moody's and S&P are not just predictions of future valuation but a present analysis of current valuation. . . . To characterize them merely as predictions or opinions would undercut the necessary reliability such ratings furnish in the world of credit." 2009 WL 921381, at 11 cited in See *Abu Dhabi Commercial Bank, et al vs. Morgan Stanley & co. et al* US District Court Southern District of New York, Opinion and Order,08 civ. 7508 (SAS) August 17, 2012 at 32

[168] See *Abu Dhabi Commercial Bank,*supra note 13, p. 33.

[169]*N.Y. Times Co. v. Sullivan*, 376 U.S. 254, 279–80 (1964)). See also 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 Okla. L. Rev. p. 766.

[170]*See, e.g.*, *Compuware Corp. v. Moody's Inv. Servs., Inc.,* 499 F.3d 520, 529 (6th Cir. 2007). The standard of proof for actual malice is "that the defendant made the statement with knowledge of its falsity or with reckless disregard of its truth,at 526; *Jefferson County Sch. Dist. v. Moody's Invs. Servs., Inc.,* 175 F.3d 848, 856 (10th Cir. 1999); *First Equity Corp. v. Standard & Poor's Corp.,* 690 F. Supp. 256, 260 (S.D.N.Y. 1988).

[171]*Orange County v. McGraw Hill Companies, Inc.*, 245 B.R. 151 (C.D. Cal 1999)

"fundamentally unsound." The plaintiff alleged that S&P breached its implied duty to perform contractual services in a competent and reasonable manner by inadequately performing the analytical services underlying its ratings. S&P argued that the "actual-malice" standard shall apply even in breach of contract claim because the conduct underlying that claim involved the publication of S&P's credit rating, which is a form of constitutionally protected speech protected by the First Amendment. "The ratings could be the basis of liability only if Orange County proved by clear and convincing evidence that Standard & Poor's acted with "actual malice" -- that is, knowledge that the ratings were false - or reckless disregard of their truth or falsity." Otherwise, the plaintiff could not "avoid the First Amendment by asserting an implied contractual duty to perform the rating function competently"[172].

A similar view was taken in *Jefferson County* case where the court rejecting plaintiff's tort claims of interference with contractual and business relationships because those claims were based on speech protected by the First Amendment[173]. The Tenth Circuit Court held that "a statement of opinion relating to matters of public concern which does not contain a provable false factual connotation" will receive full constitutional protection[174]. In *Compuware Corp. v. Moody's*,[175] the allegation was defamation and breach of contract against Moody's for downgrading of its credit rating. On both defamation and the breach of contract claims, the Court held that the "actual-malice" standard shall apply and publishing a credit rating for Compuware without question involves activities protected by the First Amendment[176]. The court also held that credit rating "is a predictive opinion, depending on a subjective and discretionary weighting of complex factors … (with) no basis upon which we could conclude that the credit rating itself communicates any provably false connotation. Even if we could draw any fact-based inference from this rating such inferences could not be proven false because of the inherently subjective nature of Moody's rating calculation"[177].

In short, in addition to the First Amendment protection, if the rating agencies have reasonably investigated the credit risk that they rated, the actual malice standard shall not hold rating agencies accountable even if the rating is wrong.

iii. Constitutional protection for "private" rating services

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[172]Ibid, p. 156.
[173]*Jefferson County Sch. Dist. v. Moody's Investor's Services, Inc.,* 175 F.3d 848, 856-58 (10th Cir.1999).
[174]Ibid p. 852.
[175]*Compuware Corporation v. Moody's Investment.Services, Inc*. 499 F.3d 520, 529 (6th Cir. 2007).
[176] Ibid.
[177]Ibid p. 529.

The Courts have, however, drawn a distinction between ratings disseminated to the public at large[178] and "private" subscription services while determining the protection under First Amendment, with the latter less likely to be eligible for such higher protection. *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc*(1985)[179] is probably the only case on rating agency's liability to reach the US Supreme Court. The matter came up for adjudication after the 1970s when the rating agencies had moved from the "subscriber pay" to the new business model of "issuer pay." The case was on a matter of "private subscription service" where the Petitioner sent a report to five subscribers, regarding the credit rating of Greenmoss Builders, Inc. the Respondent construction contractor indicating that respondent had filed a voluntary petition for bankruptcy.The report was proven false, and the respondent brought a defamation action alleging that the false report had injured its reputation and seeking damages.

The Court held that the First Amendment interest in speech on matters of purely private concern is not a matter public concern[180]. Petitioner's credit report concerned no public issue but was a speech solely a private placement[181]. The report was made available to only five subscribers, who, under the subscription agreement, could not disseminate it further, it cannot be said that the report involved any strong interest in the free flow of commercial information.[182] And the speech here, like advertising, being *solely* motivated by a desire for profit, is hardy and unlikely to be deterred by incidental state regulation[183]. While the First Amendment affords media defendants' great protection, when they are reporting on issues of "public concern," non-media defendants cannot use that same protection when their actions cause damages to private parties[184]. The First Amendment does not protect the speech of a non-media party (rating agencies), when its actions create slander and/or libel against another private party.

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[178] Public credit ratings are ratings which are disseminated via real time posts on websites and through wire feed to the news media as well as via subscription services such as Ratings Direct and Credit Wire.

[179] *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc*472 U.S. 749 (1985)

[180] *New York Times Co. v. Sullivan* 376 U.S. 254bars media liability for defamation of a "public official" absent proof of actual malice. However, if defamatory falsehoods about an individual who is neither a public official nor a public figure, the publisher cannot claim the *New York Times* protection against liability for defamation on the ground that the defamatory statements concern an issue of public or general interest. *Gertz v. Robert Welch, Inc.,* 418 U.S. 323, 339-348 (1974). In other words, a lesser standard of proof is only required for a private individual to collect damages. See Carole J. Kellerman, "Case Note: Actual Malice Standard and Punitive Damages: *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.,* 105 S. Ct. 2939 (1985)" (1986) 54 *University of Cincinnati Law Review* 1375.

[181] *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc at* 750.

[182] Ibid p. 762

[183] Ibid p. 761-763

[184] Ibid pp. 763-764.

The above decision was relied on by the US lower courts in *Abu Dhabi Commercial Bank, et al, vs. Morgan Stanley*[185] and *In re National Century Financial Enterprises, Inc., Investment Litigation*,[186] where it was held that ratings on securities sold in private placements, as distinct from public offerings, do not constitute matters of public concern, and do not qualify for full First Amendment protection[187]. For instance, in *Abu Dhabi Commercial Bank* case*,* the plaintiffs claimed that the defendants gave the Structured Investment Vehicles (SIVs) inflated ratings and rating companies (Moody's and S&P) compensation was based on the notes receiving the desired ratings. The plaintiffs' suit included claims for common law fraud, negligent misrepresentation, breach of fiduciary duty and contract, and unjust enrichment. The Court rejecting the First Amendment protection 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 same protection[188].

VII.1.ii Post crisisjudicial trends

The general judicial trend, thus, seem to be towards limiting the First Amendment protection to only public rating services, not for private subscription ratings for profit mostly made by institutional investors. However, even in the absence of constitutional protection, the negligence standard (actual malice standard) shall remain a prerequisite for liability and damages. The trend may change the regulatory landscape for rating agencies since structured finance products account for most of the rating agencies' income and the institutional investors, which include public pension and sovereign wealth funds, are the sole investors[189].

Interestingly, in 2013 S&P, Moody's and Morgan Stanley, entered into a $225 million confidential settlement (without admitting liability) in a suit claiming that they concealed risks in two mortgage-related deals called Cheyne and Rhinebridge that collapsed during the financial crisis[190]. The case was filed in U.S. District Court, Southern District of New York, with a dozen plaintiffs

[185]*Abu Dhabi Commercial Bank, et al, vs. Moody's Investors Service, Inc.,* No. 08 Civ. 7508, 2009 U.S. Dist. LEXIS 79607 651 F. Supp. 2d 155 (S.D.N.Y. 2009).
[186]580 F. Supp. 2d 630, 640 (S.D. Ohio 2008).
[187] John Crawford, "Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives in the Credit Rating Industry" (2009) 42 *Connecticut law Review - CONNtemplations* p. 13, *Business Law Case Brief*, http://www.wcl.american.edu/blr/documents/AU_BLBFall09_NewsBriefs.pdf
[188] Here, plaintiffs have plainly alleged that the Cheyne SIV's ratings were never widely disseminated, but were provided instead in connection with a private placement to a select group of investors, *Abu Dhabi Commercial Bank,* supra note 185, pp. 175–176.
[189] Crawford, "supra note 187, p. 13.
[190] Jeannette Neumann, "Cost of Ratings Suit: $225 Million" *The Wall Street Journal*, April 29, 2013.

claiming for inflating and concealing risks in mortgage-related deals[191]. The U.S. District Judge in an August 2012 summary judgment partly upheld the claims made by the plaintiffs.[192] The court had cited several pieces of that correspondence as evidence indicating that Morgan Stanley pressured the rating agencies to issue ratings it did not believe were accurate[193].

The judicial change in approach, post crisis, is evident other common law jurisdictions. The 2012 Australian Federal Court may prove to be a trendsetter and is encouraging from the investor's point of view. In *Bathurst v. LGFS, et al*,[194] a class action brought by 13 Councils, sued the Local Government Financial Services Pty Ltd (*LGFS*), the ABN Amro Bank and S&P for the loss of more than 90 percent of their original Aus$17 million invested in less than two years of investmentsuffered due to their investment innew financial product known as the constant proportion debt obligation (CPDO)[195]. The CPDO was sold in 2006 by ABN Amro, rated as AAAby S&P and bought by LGFS for the councils.CPDOs cashed out in 2006. The investors claimed that they had been induced to invest in the CPDO in reliance upon the AAA rating that S&P had assigned to the CPDO, and so the local councils could recover losses from S&P, along with the other two defendants.

The Federal Court of Australian held that a rating agency, S&P, owes a "duty of care" to potential investors in the calculation and dissemination of the ratings (both under common law and statutory liability[196]) and is liable to pay damages in equal proportions (33 1/3% each) with ABN Amro and LGFS. The Court noted that S&P made "unjustified and unreasonably" assumptions on volatility (of 15% rather than 25%), induced by misrepresentation from ABN Amro, *inter alia*, led to the CPDOs being rated AAA by S&P. Even after becoming aware of mistakes the second issue of CPDOs was also rating AAA. Though S&P had made adequate disclosures on the potential risk of

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[191]The cases are *Abu Dhabi Commercial Bank et al* supra note 185; and *King County, Washington et al v. IKB Deutsche Industriebank AG* et al, No. 09-08387, http://www.foxbusiness.com/news/2013/04/29/settlement-cost-for-moodys-sp-morgan-stanley-is-225-million-wsj/#ixzz2daBQCuEU.A jury trial was set to start May 13, 2013 in a federal court in New York.

[192]*Abu Dhabi Commercial Bank,* supra note 13.

[193] For example, an email where S&P's lead analyst on the Cheyne SIV deal wrote: "I had difficulties explaining 'HOW' we got to those numbers since there is no science behind it." Jeannette Neumann, "Cost of Ratings Suit: $225 Million", *The Wall Street Journal*, April 29, 2013.

[194]*Bathurst Regional Council v Local Government Financial Services Pty Ltd et al (No.5)* [2012] 1200.

[195] CPDO was a complex, highly leveraged credit derivative, operating over term of 10 years, within which the CPOD would make or lose money through notional credit default swap contract (CDSs) referencing two CDS indices known as the CDX and iTraxx indices (together, weighted 50% each, known as the GloboxxindexIf the CPDO NAV fell below 10%, the CPDO would cash-out in which event investors would lose all but 10% of their principal less fees and charges payable to the SPV and ABN Amro as the arranger. See *Summary of Bathurst Regional Council v Local Government Financial Services Pty Ltd* (No 5) [2012] FCA 1200, paras, 3, 8.

[196] S&P's conduct in calculating and disseminating the ratings breached sections 1041E (making false and misleading statements) and 1041H (engaging in conduct which is misleading or deceptive) of the Corporations Act 2001 and Section 12DA of the Australian Securities and Investments Commission Act 2001.

CPDO in their report, the Court inferred that S&P never expected that investors would all obtain, read and understand those reports, and S&P did not believe it was *necessary* for investors to do so in order to understand S&P's rating[197].

On the question of rating as an "opinion," not a representation, it was noted that the expression of opinion will carry with it a representation if the circumstances are:

> (a) where the person expressing the opinion knows that another person will or may act in reliance on the opinion, and (b) where the person expressing the opinion professes to have an expertise in forming and giving opinions of the kind in question. S&P is within both categories. In expressing opinions in those circumstances, the opinions [carry] with them not only a representation that the opinions were in fact held by S&P "but also (a) that the opinions were based on reasonable grounds, (b) that they were the product of due care and skill and (c) that they were, after making due allowance for their nature as opinions… safe to be relied upon and not outside the range of latitude properly to be allowed to them[198].

The Court recognized the rating as an opinion "but rely on it as an expert opinion carrying with it the representations (at the least) that S&P based the opinion on reasonable grounds and that the opinion was the result of the exercise by S&P of reasonable care and skill"[199].The Court agreed that even if rating is an opinion, the question is not whether there is a single correct answer to the putative question of what (if any) rating the CPDO "should have been assigned by S&P, but whether S&P had a reasonable basis for holding and expressing the opinion which it did[200].

The Court also concluded that the S&P rating of AAA of CPDO notes was "misleading and deceptive" and involved the publication of information or statement false in material particulars and otherwise involved negligent misrepresentations to the class of potential investors in Australia, … because by the AAA rating, there was conveyed a *representation* that in S&P's opinion, the capacity of the CPDO to meet all financial obligations was 'extremely strong,' and a *representation* that S&P had reached this option based on reasonable grounds and as the result of an exercise of reasonable case when neither was true and S&P also know not to be true at the time made[201]. Given the high volatility of the CPDO, the Court held that any reasonably competent rating agency in the position of S&P could not have rated the CPDO with such a high rating on any "rational or reasonable basis," and that as a result of S&P's negligence, the investors suffered loss and damage by relying upon S&P's AAA rating in forming their decision to invest.

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[197]*Bathurst* supra note 194, para. 1466 *Emphasis added.*
[198]Ibid, para.2416
[199]Ibid, paras 2436, 2479.
[200] Ibid.
[201]*Bathurst Summary* supra note 195, para 53.

The Court also agreed with the view that the potential liability is not indeterminate in amount, class or time. The potential liability on each rated instrument is capped; the duty to care owed by S&P is limited to a class of buyers, which could be objectively ascertainable; and the duration of potential liability was not indeterminate, but limited to 10 years or until S&P decide to withdraw its rating[202]. Finally, the Court also rejected the argument that the unforeseeable event, Global Financial Crisis (as intervening circumstance), was the real, essential or effective cause of the loss or damage incurred by the councils[203]. The court held: "… the GFC itself might not have been reasonably foreseeable, does not mean that the harm was not reasonably foreseeable. It is the class of harm which must be reasonably foreseeable rather than the "precise sequence of events" leading to the harm"[204].

The judgment has serious implications on the rating agencies. Investors in Australia who relied on the rating could now recover losses. S&P has already decided to challenge the findings at the appellate stage[205]. This decision may encourage investors in other jurisdictions to pursue against rating agencies[206]. This case, as in the recent US cases discussed above, were disputes relating to 'structural finance' products, where the rating agencies have been found to be considerably lax in their quality of rating. As some of the document filed as evidence in the US courts details, most ratings in SIV are manipulated and have been "brought" by the issuers. For the rating agencies, these structured products are "cash cows" composing now a majority of their revenue[207]. Indeed, the Australian decision was based on rating, which was product specific (CDPO) designed for a few specific investors. It is yet to be seen whether the ratio of this case would protect investors at the bottom of the pyramid, or may be considered as inadmissible because of the 'indeterminacy' of the class. Going by the tone of the court, the standards may get extended to individual investors.

The reasoning in this case could further be tested in the large number of claims that has been filed against S&P by IMFAustralia, a company that funds large legal claims, on behalf of 90 churches, councils and charities that lost millions on synthetic derivatives[208]. The Australian case has

[202]*Bathurst* supra note 195, paras. 2412, 2413 and 2456.
[203]*Bathurst* ibid, para. 2876.
[204]*Bathurst* ibid, para.2824 citing *Sydney Water Corporation v Turano*(2009) 239 CLR 51; [2009] HCA 42, p. 46.
[205]Julian Bajkowski, "S&P vows vigorous defense against councils' 'lawsuit is without merit'", *Government News*, 19 April 2013.
[206]Steven W. Fleming and RionaMoodley, "Australian Federal Court Paves the Way for Actions against Financial Product Ratings Agency" November 2012, http://www.jonesday.com/australian_federal_court/.
[207] In 2006, structured finance accounted for forty-four percent of Moody's business, while traditional corporate finance accounted for just thirty-two percent. Joshua D. Coval et al., "The Economics of Structured Finance" 3–4 *Harv. Bus. Sch. Fin. Working Paper No*. 09-060, Oct. 20, 2008, http://ssrn.com/abstract=1287363.
[208]Bajkowski, supra note 205.

already opened a floodgate and S&P is facing similar lawsuits in The Netherlands, US, UK and New Zealand. A lawsuit is filed in the Amsterdam City Courttargeting S&P, as well as, Royal Bank of Scotland, which bought parts of ABN Amro in 2007[209]. Similarly, US Justice Department may proceed with the US$ 5 billion lawsuit accusing S&P of misleading investors by inflating its credit ratings[210].

IV.2 StatutoryLiability Regime Governing Rating Agencies

IV.2.i US liability framework

Despite the rating agencies being around for over a century, there was relative absence of law for rating agencies in most jurisdictions. Rating agencies were not subject to the same fiduciary duties and "gatekeeper" liabilities faced by other financial intermediaries (like investment analysts and auditors)[211].States in general saw no reason to impose any statutory or liability framework. The dominant view has been that given the reputational capital historically established, legal intervention was not warranted, and the market forces may be sufficient for rating agencies to self-regulate[212].Rating agencies were "officially shielded from liability for all but fraud under the securities laws" and are "not held even to a negligence standard of care for their work"[213]. The Credit Ratings Reform Act of 2006, introduced after the Enron debacle, did not institute any private right of action. In fact, according to Kettering, the Act could be read to immunize the rating agencies completely from tort liability on account of allegedly inaccurate ratings[214].

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[209] Lukas Becker, "Dutch counsel confident of success as S&P faces new CPDO case" *Risk Magazine* 30 Jan 2013, http://www.risk.net/risk-magazine/feature/2238965/dutch-counsel-confident-of-success-as-s-p-faces-new-cpdo-case

[210]The Financial Institutions Reform, Recovery and Enforcement Act, 1989 allows the government to seek penalties for losses affecting federally insured financial institutions. "Judge Lets US Pursue $5 Billion Fraud Lawsuit Against S&P" 17 July 2013 http://www.moneynews.com/FinanceNews/judge-S-P-fraud-lawsuit/2013/07/17/id/515495

[211] Frank Partnoy, "How and why credit rating agencies are not like other gatekeepers", *University of San Diego School of Law, Law and Economics Research Paper No*. 07-46, May 2006, pp. 59-102; UweBlaurock, "Control and Responsibility of Credit Rating Agencies" (2007) 11 (3) *Electronic Journal of Comparative Law*.

[212] Gregory Husisian, "What standard of care should govern the world's shortest editorials? An analysis of bond rating agency liability" (1990) 75 *Cornell L. Rev.* pp. 411-461.

[213]*Report: Watchdog* supra note 8.

[214] The Act was amended at the last-minute on the Senate floor. Kettering 2008 supra note 38 p. 1688. Sec 15E(c)(2) of the SEC Act of 1934, as added by the 2006 legislation, which reads in full as follows:

> (2) Limitation—The rules and regulations that the Commission may prescribe pursuant to this title, as they apply to nationally recognized statistical rating organizations, shall be narrowly tailored to meet the requirements of this title applicable to nationally recognized statistical rating organizations. *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*. (emphasis added)

The Securities Act 1933, Rule 436(a) provides that "any portion of the report or opinion of an expert is quoted or summarized in a registration statement or prospectus, the written consent of the expert must be filed as an exhibit to the registration statement and must expressly state that the expert consents to such quotation or summarization". An express exception to the Rule provides that the security rating assigned to any class of debt securities, convertible debt, or preferred stock by an NRSRO is not considered part of a registration statement prepared or certified by an expert[215]. In other words, the NRSROs are not experts for purposes of Section 7 and Section 11 of the Securities Act, and their consent is not required if an issuer includes a credit rating in a registration statement. The Rule 436(g), thus, immunizes NRSRO from civil liability for misstatements in a registration statement under Section 11 of the Securities Act of 1933[216].

In 2010, the *Carpenters Fund and Boilermaker* case[217] claimed that the rating agencies had directly participated in the formation and structuring of the Certificates prior to issuance as "underwriters" and has violated Sections 11, 12, and 15 of the Securities Act, by omissions and misstatements in registration statements and prospectuses filed with SEC. The court dismissed those claims at the pleading stage because "the alleged activities are insufficient to impose "underwriter" liability under section 11"[218]. The Court noted that the CRAs activities were not necessarily innocent; however, "they were not related to the core functions of an underwriter, i.e. the marketing, distribution, and sale of offerings to investors[219]. Further, the plaintiff claim under Section 15 failed because of plaintiff's inability to demonstrate primary liability under sections 11 and 12[220].

The Dodd Frank Act for the first time recognizes statutory civil liability for rating agencies. The Act incorporated a liability standard similar to other "gatekeepers" such as the registered public

[215] Rule 436(g)(i), General Rules and Regulations promulgated under the Securities Act 1933.
[216] The repeal of Rule 436(g) has the effect of putting NRSROs on equal footing with other credit rating agencies. Danielle Carbone "The Impact of the Dodd-Frank Act's Credit Rating Agency Reform on Public Companies" (2010) 24 (9) *Insights* p. 2.
[217]*New Jersey Carpenters Vacation Fund et al, v. Royal Bank of Scotland*, et al. Group, 08 CV 5093 (HB) Opinion and Order, District Court Southern District of New York, 26 March 2010. http://securities.stanford.edu/1040/HVMLT_01/2010326_r02o_08CV5093.pdf
[218]Ibid, p. 2, 9.*See In re Lehman Brothers Secs. and ERISA Litig.,* No. 09 MD 2017 (LAK), 2010 WL 337997 (S.D.N.Y. Feb. 1, 2010). According to Judge Kaplan, while "the Rating Agencies' alleged activities may well have a good deal to do with the composition and characteristics of the pools of mortgage loans and the credit enhancements of the Certificates that ultimately were sold…. there is nothing in the complaint to suggest that they participated in the relevant 'undertaking'-that of purchasing the securities here at issue, the Certificates-'from the issuer with a view to their resale.'"
[219]Ibid at 10. See 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* p. 190.
[220]Ibid p. 11 citing in *In re Morgan Stanley Info. Fund Secs. Litig*., 592 F.3d 347, 358 (2d Cir. 2010).

accounting firm or a securities analyst under the securities laws[221]. Investors can bring private rights of action against ratings agencies for a *knowing or reckless* failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source[222]. Plaintiffs will have to plead that the rating agencies "*knowingly or recklessly* failed - (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (ii) to obtain reasonable verification of such factual elements. . ."[223]. In addition, rating agencies statements will not be considered forward-looking for purposes of the safe harbor provision in Section 21E of the SEC Act[224]. Similar in case of a claim for damages brought against a CRAs or a controlling person, a strong inference of the CRAs knowing or reckless failure would suffice[225].

The Act repealed immediately Rule 436(g) which means that CRAs is subject to "expert liability" under Section 11 of the SEC Act when credit ratings are included by reference into a registration statement or prospectus[226].In rescinding Rule 436(g) the standard of liability to rating agencies is now in par with the auditors, securities analysts, and investment bankers." The SEC may also deregister an agency for providing bad ratings over time. Rating agencies have already indicated that they would not give consent to allow their organizations to be named as experts in registration documents filed with the SEC[227]. For instance, Ford Motor Credit was forced to postpone the launch of a $1 billion public offering because the SEC Regulation required to disclose credit ratings and the inability of the issuer to secure consents from the NRSROs in light of the repeal of Rule 436(g)[228].

IV.2.i EU liability framework

The EC, similar to its US counterpart, imposes civil liability on rating agencies by incorporating a new Article 35a(1) into Regulation 1060/2009:

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[221]Sec. 933 Dodd-Frank Act 2010.The Act states that "for the purpose of enforcement and penalty, the statements made by a credit rating agency shall be treated in the same manner and to the same extent as statements made by a registered public accounting firm or a securities analyst under the securities laws"

[222] Brief Summary of the Dodd-Frank Act, supra note 120.

[223] Sec 933, Dodd-Frank Act (emphasis added).

[224]Ibid.Forward-looking statements are exempt from liability under Section 21E of the Exchange Act. Securities and Exchange Act of 1934, § 21E, 15 U.S.C.S. § 78u -5 (2010). Stephen P. Alicanti, "A Pattern of Unaccountability: Rating Agency Liability, The Dodd-Frank Act, and a Financial Crisis That Could Have Been Prevented" (2011) ExpressO p. 50, http://works.bepress.com/stephen_alicanti/4.

[225] Brief Summary of the Dodd-Frank Act, supra note 120.

[226]Sec 939G Dodd-Frank Act 2010. Danielle Carbone "The Impact of the Dodd-Frank Act's Credit Rating Agency Reform on Public Companies" (2010) 24 (9) *Insights* p.1.

[227]Steven G. Brody et al, "Dodd-Frank Act's Impact on Rating Agencies as the ABS Market Continues to Evolve," Dec. 15, 2010, http://www.bingham.com/Media.aspx?MediaID=11652.

[228]Ibid.See also Carbone, supra note226, p. 1 at fn5.

> 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. . .[229].

The EC CRA Regulation recognizes thatthe investors and issuers are not always in a position to enforce CRAs' responsibility towards them. For instance, a credit rating downgrade, a decision based on an infringement of EC Regulation committed intentionally or with gross negligence, can impact negatively the reputation and funding costs of an issuer, therefore, causing this issuer damage even if it is not covered by contractual liability. Since different methodologies may lead to different rating results, none of which can be considered as incorrect, it is appropriate to expose CRAs to potentially unlimited liability only where they breach EC Regulation intentionally or with gross negligence[230].

An investor can claim damages 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. Similarly, an issuer can claim damages where it establishes that it or its financial instruments are covered by that credit rating and the infringement was not caused by misleading and inaccurate information provided by the issuer to the CRA, directly or through information publicly available. Any limitation or exclusion of civil liability shall have no legal effect[231].

Those aspect of civil liability of a CRA which are not covered by or defined in the Regulation, including causation and the concept of gross negligence, is governed by the applicable national law as determined by the relevant rules of private international law. The terms such as "damage", "intention", "gross negligence", "reasonably relied", "due care", "impact", "reasonable" and "proportionate" shall be interpreted and applied in accordance with the applicable national law as determined by the relevant rules of private international law[232]. The Regulation encourages States to maintain a civil liability regime which are more favourable to investors or issuers or, which are not based on an infringement of EC CRA Regulation[233].

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[229] Article 35a, Civil liability, Article 35a was inserted into Regulation 1060/2009 by Regulation (EU) No 462/2013.
[230]Para 32.Introductory note to the enactment, EU CRA Regulation 1060/2009.
[231] Article 35a(3), Regulation 1060/2009 as amended Regulation (EU) No 462/2013. The UK law however, allows limitation on liability. See Regulation 9, UK Credit Rating Agencies (Civil Liability) Regulations 2013.
[232]Article 35a.4, Regulation 1060/2009 as amended Regulation (EU) No 462/2013.
[233]Para 35, Introductory note to the enactment, EU CRA Regulation 1060/2009.

The UK Credit Rating Agencies (Civil Liability) Regulations 2013[234]defines an infringement as an act committed *intentionally* or *with gross negligence*if the senior management[235] acted *deliberately to commit the infringement* or has been *reckless,* i.e., if they act without caring whether an infringement occurs[236]. For both investors and issuers under a contract with a rating agency, the level of damages recoverable will be the damages recoverable in accordance with that contract. Where there is no contract then the damages recoverable by an issuer will be the increased cost of financing resulting from the relevant credit rating; in contrast, 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 against the rating agency. A one year limitation period for bringing a claim will apply[237].

V. Conclusion

To conclude, the rating agencies entered into a new era post financial crisis. From a period marked by regulatory absence, the proposed legal regime controls every aspect of the agencies functioning and could fundamentally change the way they function. The regulatory interventions are invasive in the sense that the measures not only attempt to increase control over agencies and enhance public scrutiny and disclosure of theirconduct and methodologies, but also attempt to reduce reliance and severely diminish their role in the financial market. The intended targets of most of these measures are the "big three"rating agencies. Stringent measures are restricted to the rating of structured financial products. The smaller CRAs are spared from the onerous obligations with the objective ofpromoting competition. Though measures have been adopted to improve internal governance and reducing conflict of interest, the "user pay" model of revenue generation would remain to be hurdle.

From now on, rating shall cease to be considered as just an option issued in interest public, and no more can the rating agencies hide behind the vile of freedom of speech and the defense of First Amendment. Increasingly, the Courts in US and elsewhere are increasing subscribing to a view that the ratings are not just predictions of future valuation but a present analysis of current valuation.

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[234]UK Credit Rating Agencies (Civil Liability) Regulations 2013 came into force on 25 July 2013.

[235] As par UK Regulation 2, "senior management" has the meaning given by EC Regulation article 3(1)(n) means "the person or persons who effectively direct the business of the credit rating agency and the member or members of its administrative or supervisory board".

[236]UK Regulations 3, 4, ibid.

[237] Simon Garrett and Chris Bradshaw, "Liability of Credit Rating Agencies – UK regulations come into force on 25 July 2013" United Kingdom, July 10 2013 at http://www.lexology.com/library/detail.aspx?g=39cd8e98-a104-4849-ad03-1e445b9dba76.

“To characterize them merely as predictions or opinions would undercut the necessary reliability such ratings furnish in the world of credit”. In the Australian jurisdiction at least, we have seen thatratings as an expert opinion shall carry an expectation that it must be based on reasonable grounds and the rating agencies have exercisedreasonable care and skill. Such expert opinion shall be considered as a representation, thereby making the rating agency accountable for such representation.

The US and the EU, for the first time introducedstatutory liability for wrongful ratings and recognized the right private to action. The threshold of proof required to attribute liability however has been kept high, i.e., ‘intention” or “knowledge”, or “grossly negligence”standard which has been equated with the “recklessness.” For EU, the mere recognition of tort liability at European level is in itself is an enormous leap.Whereas,the courts in US, based on common law cause of action, had long established the need to prove intent to defraud or “actual malice” (knowledge of falsity or reckless disregard for the truth) to attribute liability. In other words, negligence by itself shall not attract liability even when a rating is false, in the absence of proof of actual or express malice.If the rating agency has reasonably investigated the credit risk even if the rating is wrong, the actual malice standard shall not hold accountable.Such higher threshold would avoid exposing CRAs to unnecessary claims thereby interfering with their functioning.

Rating agencies are unquestionably an integral part of the international financial landscape. At the same time, the need for a strong regulatory intervention is well reasoned and much needed, given the fact that they knowingly faltered in their assessment of credit risk motivated by profit, losing their impartiality and credibility in the process. The measures have been path breaking in several aspects, and the US has taken the lead in diminishing the role of rating industry in a credit market. The Europe has largely taken a more balanced approach towards total elimination of external ratings, and this may remain so until a viable alternative is found. Total elimination of rating agencies seems to be farfetched and undesired under the present circumstance.

At the receiving of the regulatory onslaught was the “big three” rating agencies. It was their actions in the rating of structure financial products and the sovereign debt that provoked the regulatory actions. For them, it would be an uphill task to rebuild the credibility and reputational capital lost during the process. For the smaller rating agencies, the US and the EU has given ampleregulatory space and opportunity, which could be taken advantage of in entering the rating space which was otherwise oligopolistic. In the diminished role and higher accountability for rating agencies, the real impact of these regulations could only be assessed in time to come, as most regulations are yet to be put in place or are in the implementation cycle. The threat of a European

rating agency and other proposals in similar lines adds to existing challenge posed to the existing players.The rating agencies may adapt to changing legal environment, however, the future of the industry would depend much on how effectively they could overcome the legitimacy test. Indeed, one must note that the flaws in the rating industry are only a reflection of the problems inherent in the financial industry as a whole. Blame shall also rest with the State for their role in creating such a market condition of impunity. The way forward is to strengthen the existing systemfrom an investor's perspective, a system that could heighten predictability and reduce risk, rather than, finding an alternative which may be cumbersome and costly.