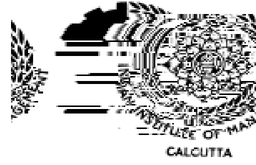

Indian Institute of Management Calcutta

Working Paper Series

WPS No. 746
June 2014

RATING AGENCIES

R Rajesh Babu

Associate Professor
Indian Institute of Management Calcutta
Diamond Harbor Road, Joka, Kolkata 700104
INDIA
http://facultylive.iimcal.ac.in/workingpapers

RATING AGENCIES

R. Rajesh Babu*

Contents

I. Introduction

II. Role of Credit Rating in the Financial System
- II.1 Credit rating definitions and principles
- II.2 Rating Agencies as de facto regulators
- II.3 Role of CRAs in the current financial crisis

III. Regulatory responses of States
- III.1 International response and collective action plan
- III.2 National/Regional Responses
    - i. Institutional arrangement for Supervision and implementation
    - ii. Eliminating “hardwiring” and reducing reliance on credit ratings
    - iii. Increasing scrutiny of rating agencies conduct and methodologies
    - iv. Rating agencies liability and accountability for ratings
    - v. Corporate governance and reducing conflict of interest issues
    - vi. Sovereign ratings

IV. Emerging liability regime for Rating Agencies
- IV.1 Judicial approach to rating agencies liability
    - i. Liability of Rating Agencies in common law
        - Rating agencies’ “duty to care”
        - Rating as “opinion”
        - Constitutional protection for “private” rating services
    - ii. Post crisis judicial trends
- IV.2 Statutory Liability Regime Governing Rating Agencies
    - i. US liability framework
    - ii. EU liability framework

V. Conclusion

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 Europe as they have set a trend followed by other countries.

*Associate Professor, Indian Institute of Management Calcutta. Email: rajeshbabu@iimcal.ac.in
My sincere thanks to Dr. Michael Waibel for his comments. All errors are mine. ©R. Rajesh Babu

I. Introduction

on the practices and regulatory interventions in the US and the Europe as they 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]

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]

[9] “Rating Symbols & Definitions,” Moody’s Investors Service (July 2010),

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

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

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]

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 ratings transformed 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

---

[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: Watchdogs, 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 bank's 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 Publique Franraise 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",

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 contextublic corpo6emarket.5(rk)-5.prodact8 Tw [ig18 TD ured larcial m.

55.9(r)-7.3(g 7(8a2(gan1 5ge(8a2(nan1 5)4..Tc (es ..Tc (n)g 5(t.Tc (han1 5ge 23 Eu)g 5(ro)g 5(pe

…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]

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 Ratingt-5.2eo(ciples0 Su

firstinterim report has found that the US and the EU has made considerable progress in removing

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 2011, 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 "Publie Maruef.6(8)-4.p"P p2 ee M4(o.1(f/ns)7ndu)f(e).9o6(2)4 r(e).9 Sf/ un(e).9v6(2)4 M4(ef.6(8o.1(f/railedyT

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].

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 details 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

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

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

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]

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 five years, 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'

---

[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.vi Sovereign 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 and Germany, felt that 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 rating shall 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

[131] Article 6b.1, ibid.
[132] "Credit rating rotation diluted by MEPs," 20 June 2012, http://www.euractiv.com/euro-finance/credit-rating-

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]. Though the judicial process has been used in some jurisdictions to attribute liability for

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

---

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, 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]

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

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:

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

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 conditional 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 value 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 “actua

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 crisis judicial 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 13,

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 invest in less than two years of investment suffered due to their investment in new financial product known as the constant proportion debt obligation (CPDO)[195]. The CPDO was sold in 2006 by ABN Amro, rated as AAA by 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

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

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

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

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 Boilermakers 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]

accounting firm or a securities analyst under the securities laws.[221] Investors can bring private rights of action against ratings agencies for 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]

Where a credit rating agency has committed, intentionally or with gross negligence,

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.

[234] UK Credit Rating Agencies (Civil Liability) Regulations 2013 came into force on 25 July 2013.
[235]

“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 exercised reasonable 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

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 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.