Civil Liability of Rating Agencies

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Introduction

Credit Rating Agencies (CRAs) have been in the limelight since the onset of the financial crisis. In the beginning, they were accused of having overestimated the quality of structured financial instruments (Asset-Backed Securities – ABS) that pooled together subprime and other mortgage-loans.[1] Later, they were suspected of having treated sovereign debtors too harshly, especially those in Southern Europe, with the result that these states faced sharp increases in public refinancing costs, which accelerated their economic downturn.[2]

The public outcry against the seemingly all-too-powerful and unregulated rating agencies has incited a transnational legislative movement to subject them to greater scrutiny. In the United States, the Dodd-Frank Act has established a comprehensive framework for regulating CRAs.[3] Yet the most vigorous regulatory assault on rating agencies today stems from the European Union. After having introduced a regulation on them in 2010 (the "CRA Regulation"),[4] it has overhauled this regime since then three times. The first amendment was introduced only eight months after the regulation's completion.[5] The second amendment followed only one month later.[6]

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[1] See A. M. Grinshteyn, Horseshoes and Hand Grenades: The Dodd-Frank Act's (Almost) Attack on Credit Rating Agencies, 39 Hofstra L. Rev. 937, 944 (2010-2011); S. McNamara, Informational Failures in Structured Finance and Dodd-Frank's Improvements to the Regulation of Credit Rating Agencies, 17 Fordham J. Corp. & Fin. L. 665, 685 et seq. (2012); R. Voorhees, Rating the Raters: Restoring Confidence and Accountability in Credit Rating Agencies, 44 Case W. Res. J. Int'l L. 875, 879-880 (2011). For a very early assessment of criticism, see C.A. Frost, Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies, Journal of Accounting, Auditing and Finance 22 (2007), 469, 475 et seq.

[2] See, e.g., the criticism with regard to the four notch downgrade of Portugal by Moody's in 2011, FT, 6 July 2011, Portugal hits back at Moody's downgrade.

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Publ. L. 111-203, 124 Stat. 1376, Title IX Subtitle C, sec. 931 - 931H.

[4] Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, OJ L 302, 17.11.2009, p. 1.

[5] Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies, OJ L 145, 31.5.2011, p. 30.

The most recent reform happened in May 2013.[7] Except for banks, no other financial intermediary receives as much attention from the European legislator as rating agencies. The EU, to a certain degree, can be held to be "CRA obsessed".

The latest amendment aims at reducing reliance on ratings, guaranteeing more stability for sovereign issuers, enhancing the quality of structured products ratings, and increasing the transparency of ratings.[8] Its main innovation, however, is the introduction of civil liability for rating agencies. To this end, a new Article 35a is inserted into the CRA Regulation, which permits investors and issuers to recoup losses attributed to incorrect ratings. This paper will analyse first whether rating agencies should be subject to civil liability (A). It will then show how the new provision turns the hierarchy between EU law and Member State law upside down (B). Finally, some important conflict of law issues will be examined (C).

A. Should Civil Liability Be Imposed on CRAs At All?

1. The Economic Function of CRAs

Credit Rating Agencies (CRA) fulfil an important function in financial markets by serving as information intermediaries.[9] They provide independent and ongoing assessments of an issuer's creditworthiness (issuer rating) and the quality of its financial instrument(s) (issue rating). These ratings are used by investors and supervisory authorities alike. Under the current "issuer-pays model", they receive this information for free since the issuer pays the agency to acquire a rating. Because most ratings are made available to the general public, and can be shared without diminishing their intrinsic value, a public good is created.[10]

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[6] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011, OJ L 174, 1.7.2011, p. 1.

[7] Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies, OJ L 146, 31.5.2013, p. 1.

[8] See Art. 5a-c, 6a-b, 8a-d, 13 of the CRA Regulation as introduced or amended by Regulation 462/2013.

[9] See generally C.E. Bannier and C.W. Hirsch, The economic function of credit rating agencies – What does the watchlist tell us?, Journal of Banking and Finance 34 (2010), 3037; P. Behr & A. Güttler, The informational content of unsolicited ratings, Journal of Banking and Finance 32 (2008), 587; A.W.A Boot, T.T. Milbourn and A. Schmeits, Credit Ratings as Coordination Mechanisms, Review of Financial Studies 19 (2006), p. 81–118.

[10] See S.L. Schwarcz, Disclosure's Failure in the Subprime Mortgage Crisis, 3 Utah L. Rev. 1109, 1120-1121 (2008).

By independently evaluating issuers and their financial instruments, rating agencies reduce information asymmetries on the capital markets. If they did not exist, such an evaluation would have to be carried out by each investor individually. By placing this activity into the hands of a few institutions, efficiency gains are achieved. These gains are even increased by that fact that the rating agencies have access to privileged information and the expert knowledge to independently conduct assessments, which individual investors normally do not dispose of.

From a macroeconomic viewpoint, rating agencies act as “gatekeepers”.[11] Through their rating, they indirectly control the entry of new risks on the financial markets. By giving information about the creditworthiness of issuers and the quality of their instruments, they allow to adequately price the default risk of these issuers and instruments. Thanks to them, the worst issuers and instruments do not even enter the market because they cannot obtain a sufficiently good rating.

In sum, the importance of CRAs for the functioning of modern markets can hardly be overestimated.

2. Providing a Free Lunch to Investors

The new regulation introduces a statutory cause of action against rating agencies. It can be invoked by issuers and investors alike. In practice, investors may incur losses when they base their investment decisions on ratings that subsequently prove to be incorrect. Issuers may suffer harm because after being low and incorrectly rated, their costs for securing financing in the market increases.

Under the new regulation, claimants may sue CRA regardless of whether they have a contractual connection to them or not.[12] This creates a policy problem. While one can easily explain the compensation awarded to an issuer that was improperly rated by a CRA under ordinary principles of tort law, a justification is not so readily available for the claim of an investor who has suffered damage caused by an incorrect rating. An investor is not obliged to rely on the rating. Moreover, he usually does not pay for the access to the rating. The liability that arises under the CRA regulation thus seems like a gratis guarantee for the investor. He can effectively shift

[11] See F. P. Hops, Problems and Reforms in Mortgage-Backed Securities: Handicapping the Credit Rating Agencies, 79 Miss. L.J. 531, 535 (2009-2010). See also the findings of the Congress reflected in sec. 931(2) of the Dodd-Frank Act, infra ????. On the concept of gatekeepers, see generally J. C. Coffee, Gatekeepers: The Professions and Corporate Governance (2006).

[12] See Preamble 32, last sentence Regulation 462/2013.

the risk inherent in his investment decisions over to the rating agencies without incurring any direct cost.

If one were to adopt the perspective of general private law, the justification for this kind of “free lunch” may appear questionable. However, such a myopic, civilian view ignores the true goal of the CRA regulation. Civil liability in this case is not – at least not primarily – introduced to repair the damage done to the private investor. The objective is rather to deter rating agencies from providing false ratings. Precisely because CRAs fulfil important economic functions, there is a heightened need to sanction them when they violate regulatory rules. In other words, they must be deterred from publishing incorrect ratings. It is a well-known fact that imposing civil liability is an efficient method for deterrence.[13] In U.S. parlance, the investor that brings forward a damages claim acts as an “attorney general” against the agencies.[14] The imposition of private liability serves a direct, regulatory function rather than a compensatory one. Civil liability is used as a means for enforcing the regulation of rating agencies, and not as a tool to repair an investor’s damage.

3. Civil Liability as a Regulatory Tool

Some authors nevertheless argue that there is no need to impose civil liability on gatekeepers.[15] They argue that the latter need to preserve reputational capital and that providing inaccurate services would jeopardize their weight and legitimacy. Because of this, gatekeepers would be sufficiently incentivized to avoid errors. It is even claimed that introducing an additional civil liability regime for them would be dangerous. According to this opinion, it would increase gatekeeping costs and thereby potentially stop economically beneficial activities.[16]

It is certainly true that there are strong market incentives for CRAs to issue correct ratings. Several studies show, however, that the importance of reputational capital

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[13] On the role of private litigation in the enforcement of securities laws, see, e.g., J. C. Coffee, Law and the Market: The Impact of Enforcement, 156 U.Penn. L. Rev. 229 (2007).

[14] See T. Frankel, Implied Rights of Action, 67 Va. L. Rev. 553, 557 (1981); M. C. Stephenson, Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies, 91 Va. L. Rev. 93, 103-04 (2005). On the notion of the private attorney general, see William B. Rubenstein, On What a "Private Attorney General" Is - And Why It Matters, 57 Vand. L. Rev. 2129 (2004).

[15] S. Choi, Market Lessons for Gatekeepers, 93 Nw. U.L. Rev. 916, 934-49 (1997-98) (on “certification intermediaries” as gatekeepers); Howell E. Jackson, Reflections on Kay, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions, 66 S. Cal. L. Rev. 1019, 1049-72 (1993) (on lawyers as gatekeepers).

[16] In this sense S. Choi, Market Lessons for Gatekeepers, 93 Nw. U.L. Rev. 916, 948 (1997-98).

for this type of gatekeeper has been overestimated.[17] Among the reasons offered is the comparatively high entry barrier into the credit rating market. To run a CRA, considerable investment and particular knowledge is necessary. Even where this is available, it will take a long time and considerable effort to close the gap built by the reputational advances of the "big" rating agencies. Moreover, the fact that the rating methodology is quite opaque makes it difficult for new entrants to prove the quality of their service. Consequently, dominant agencies can, at least to a certain extent, rely on their clients' hesitance to shift to new competitors. Finally, there is a huge gap between short term and long-term incentives for CRAs. An agency may indeed prefer earning a "quick buck" from an issuer rather than profit from long-term gains based on reputation. The experience with commission fees in relation to structured products provides clear evidence that even big CRAs are not immune to such temptations.[18]

In sum, it is indisputable that the fear to lose reputational capital plays a considerable role in the CRA market. Nevertheless, there are several arguments that challenge the idea that this fear sufficient, in and of itself, to deter rating agencies from publishing incorrect ratings. Given the CRAs importance as gatekeepers and the economic danger resulting from incorrect ratings, a case for imposing civil liability on CRAs can be made.

4. Are State Courts Well-Positioned to Judge over CRAs?

Rating agency liability effectively allows state bodies to second guess the accuracy of credit ratings. There are at least two good reasons as to why the state, as arbiter, may not be in a favourable position to effectively exercise this power. First, state organs do not have the expert knowledge that the CRAs use to rate issuers and

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[17] See N.S. Ellis, L.M. Fairchild, & F. D'Souza, Is Imposing Liability on Credit Rating Agencies a Good Idea: Credit Rating Agency Reform in the Aftermath of the Global Financial Crisis, 17 Stan. J.L. Bus. & Fin. 175, 212-215 (2011-2012); J.P. Hunt, Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement, Columbia Business Law Review 109, 129-142 (2009).

[18] See S. Harper, Credit Rating Agencies Deserve Credit for the 2007-2008 Financial Crisis: An Analysis of CRA Liability Following the Enactment of the Dodd-Frank Act, 68 Wash. & Lee L. Rev. 1925, 1941-1945 (2011); F. P. Hops, Problems and Reforms in Mortgage-Backed Securities: Handicapping the Credit Rating Agencies, 79 Miss. L.J. 531, 548-558 (2009-2010); C. Kumpan, Conflicts of Interest in Securitisation: Adjusting Incentives, Journal of Corporate Law Studies 9 (2009), 261, 272-274.

instruments. CRAs employ sophisticated methods to assess the risk of failure.[19] The state, as arbiter, is unlikely to master these methods to the degree attained by the CRAs. Second, states may face conflicts of interest when simultaneously acting in a regulatory capacity, as supervisors of CRAs, and in a commercial capacity, as issuers. Under these circumstances, the potential to abuse their regulatory authority in order to improve their own position as an issuer exists. To avoid such conflicts, CRAs must be independent from the state when the latter acts as a borrower on the market. The autonomy of the rating system must be held intact, otherwise, market participants will not be treated on an equal footing.

Although these arguments are important, they do not imply that CRAs should be free from any liability. Despite the fact that it may be impossible for a judge to accurately reconstruct the rating, he may still be competent enough to assess whether methodological errors have been made. For instance, he may be able to determine whether a rating adequately reflected the use of all available information and conclude whether an agency adhered to its own rating models. Moreover, the principle of separation of powers guarantees that an independent judge will be responsible for assessing liability of the rating agency, and not the government in its commercial capacity as borrower.

Overall, the state is thus justified to police the activities of rating agencies and impose civil liability on them, provided that certain limits are respected. These limits are drawn by the fact that the application of a rating methodology requires particular expertise, which is bestowed only in the rating agency and not in the judge. The state is not better positioned to rate market participants than the agencies. Nevertheless, it must exercise some control over their activities.

5. Ratings as Opinions or Facts

One particular argument that is often advanced against the imposition of civil liability for ratings is that they merely constitute opinions, and not facts. This is a common defence raised by rating agencies when sued by investors or issuers.[20] It has special force in the United States because freedom of speech is comprehensively protected

[19] See e.g. C.E. Bannier and C.W. Hirsch, The economic function of credit rating agencies – What does the watchlist tell us?, Journal of Banking and Finance 34 (2010), 3037.

[20] See, e.g., the testimony of Rita M. Bolger, Managing Director and Associate General Counsel of Standard & Poor's, before the United States House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises, 109th Cong. 16 (2005).

under the First Amendment to the US Constitution. Given that the freedom of expression is also enshrined in the European Convention of Human Rights and in the Charter of Fundamental Rights,[21] the argument is of interest in the EU as well.

Quite a number of U.S. courts have opined that credit ratings enjoy First Amendment protection as so-called "commercial speech".[22] Several courts have, however, excluded ratings that were disseminated to a selected group of investors, on the basis that only public speech is protected under the First Amendment.[23] Yet from a regulatory viewpoint, the distinction between ratings distributed to a select group and ratings disseminated to the public at large seems unconvincing.[24] The interest in correct ratings does not diminish if the rating is targeted at a select group, which can in effect be quite big. Moreover, it is often impossible to distinguish between cases in which a rating is targeted at a group from those in which it is made available to the general public.[25] As an illustration, one may imagine a case where a rating that was originally directed to a group is later published by the media.

The correct distinction lies elsewhere. Given that a rating is, in fact, a forecast on an issuer's ability to honour its obligations, it is undisputed that there is a certain element of opinion built into it. Ratings are merely prognoses of the future, and as such, are subject to error even where the most exacting standards have been met. CRAs, however, do not merely state opinions. Instead, they expressly or implicitly claim to have conducted a thorough review of the financial condition of the issuer and the terms of his offer, based on a comprehensive analysis of facts. This claim is precisely why investors subscribe to their ratings. They do not rely on mere opinions, but rather on the facts that allegedly support them. If and where these facts are

[21] Art. 10 European Convention on Human Rights; Art. 11 European Charter of Fundamental Rights.

[22] See Compuware Corp. v. Moody's Inv. Servs., Inc., 499 F.3d 520, 529 (6th Cir.2007); Jefferson County Sch. Dist. No. R–1 v. Moody's Inv. 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).

[23] See Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., 651 F.Supp.2d 155, 175–76 (S.D.N.Y.2009); Genesee County Employees' Retirement System v. Thornburg Mortg. Securities Trust 2006-3, 825 F.Supp.2d 1082, 1236-1237 (D.N.M. 2011).

[24] For an equally critical account, see C. Deats, Talk That Isn't Cheap: Does the First Amendment Protect Credit Rating Agency's Faulty Methodologies From Regulation?, 110 Columbia Law Review 1818, 1846-1850 (2010).

[25] See C. Deats, Talk That Isn't Cheap: Does the First Amendment Protect Credit Rating Agency's Faulty Methodologies From Regulation?, 110 Columbia Law Review 1818, 1842 (2010), footnote 147.

wrong, liability should be imposed.[26] Even under the First Amendment to the U.S. Constitution, courts are free to regulate false and deceptive speech.[27]

In sum, there are several arguments that support limitations to the protection of free speech if it is based on incorrect facts. In light of these arguments, rating agencies should be held liable where the factual basis of their ratings is false or where they have failed to properly analyse underlying facts. Where the agency got the facts right, but simply drew the wrong conclusion, liability should not apply.

6. Reducing Overreliance on Ratings

Another argument made against imposing civil liability on CRAs is that it could lead to investors' overreliance on ratings. Such overreliance occurs when ratings form the sole basis of investment decisions or when ratings are "mechanistically" followed. In such circumstances, a creeping herd-like behaviour may take hold amongst investors, where investment decisions mirror, to an exacting degree, changes in ratings.

In response to the overreliance phenomenon, the Financial Stability Board has requested that governments reduce reliance on credit rating agencies when drafting laws and regulations.[28] This international response to overreliance has become a shared objective among national capital market regulators. In fact, one of the main purposes behind the latest amendment of the CRA regulation is precisely to transpose this goal into EU law in order to discourage overreliance on ratings.[29] Curiously though, offering investors a right of redress against rating agencies runs somewhat counter to this goal. Where such a right is provided, there is nothing safer for the investor than to rely on a rating. In cases where the common assumptions about an issuer or instrument that are expressed in a rating prove to be wrong, he can shift the risk of his investment effectively onto the rating agency. By contrast,

[26] See also J.P. Hunt, Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement, Columbia Business Law Review 109, 183-188 (2009).

[27] See Ibanez v. Fla. Dep't of Bus. & Prof'l Regulation, Bd. of Accountancy, 512 U.S. 136, 142–43, 114 S.Ct. 2084, 129 L.Ed.2d 118 (1994) ("[F]alse, deceptive, or misleading commercial speech may be banned."); Friedman v. Rogers, 440 U.S. 1, 9, 99 S.Ct. 887, 59 L.Ed.2d 100 (1979). See also in the context of ratings Genesee County Employees' Retirement System v. Thornburg Mortg. Securities Trust 2006-3, 825 F.Supp.2d 1082, 1237-1238 (D.N.M. 2011).

[28] See FSB, Principles for Reducing Reliance on CRA Ratings, 27 October 2010, available at http://www.financialstabilityboard.org/publications/r_101027.pdf (last visited 15 November 2013).

[29] See Regulation 462/2013, Preamble 9.

where the rating proves to be correct, he will keep the returns on the investment. Imposing civil liability on CRAs may thus, in fact, encourage further reliance on ratings. This paradox has led to criticism in the literature against the introduction of civil liability on CRAs.[30]

A closer look at the CRA regulation reveals, however, that the paradox may, in fact, be illusory. For one, the amending regulation's provisions on overreliance only concern financial institutions.[31] Only they are required to conduct their own credit risk assessments. Ordinary private investors would, by comparison, be completely overburdened by such in-depth financial analyses. As a result, they are not barred from continuing to rely on ratings as a primary source of investment information. If these ratings prove to be false and losses are consequently incurred, the regulation gives the investor the right to bring a claim forward.

Yet the amending regulation goes further. In its preamble, it states that the mere fact that institutional investors shall carry out their own risk assessment should not prevent courts from holding rating agencies liable towards them if they have caused damage.[32] Indeed, in light of the CRAs comparatively superior access to information, it may still be reasonable for an institutional investor to take the rating into account, at least as an additional source of information.[33] If the rating proves to be wrong, the CRA may be found liable towards the investor. However, under the amending regulation, an institutional investor is presumed to maintain the ability to counter the adverse effects of a false rating by carrying out its own research. Therefore, it will be much harder for him to show that he "reasonably relied" on a false rating, as the liability provision presupposes.[34] As a result, CRAs will be liable to institutional investors less often than to retail investors.

7. The Need to Limit CRA Liability

The foregoing analysis illustrates that there are solid arguments for holding CRAs liable when they issue false credit ratings. That said, there are several, equally good arguments for limiting their liability. First, CRAs, in their capacity as gatekeepers,

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[30] H. Edwards, CRA 3 and the liability of rating agencies: inconsistent messages from the regulation on credit rating agencies in Europe, Law and Financial Markets Review 2013, p. 186, 191.
[31] See Art. 5a CRA Regulation as introduced by Regulation 462/2013.
[32] Regulation 462/2013, Preamble 36, first sentence.
[33] See also Regulation 462/2013, Preamble 36, second sentence.
[34] See Art. 35a(1) subpara. 2 CRA Regulation.

should not be overly deterred by the risk of liability from making independent ratings by the risk of liability imposed on them if their ratings subsequently should prove to be wrong. Second, under the current issuer-pays model, investors typically do not pay for credit ratings. They thus do not deserve full protection against any mistake that the rating agency may commit; otherwise, they would have no incentive to buy ratings. Third, liability for false ratings should not be so burdensome that it effectively stops CRAs from acting as gatekeepers. Fourth, in light of the expert level of knowledge necessary to issue ratings, a judge may not have the required competence and knowledge to effectively second guess the adequacy of a rating. Fifth, the agencies can rely on free speech protection as far as their assessments are based on correct facts and are unbiased Lastly, the current policy to reduce legislative reliance on ratings would be turned on its head if agencies were always fully liable to investors.

Taken together, these points make a strong argument for limiting rating agencies' liabilities. The problem is that these limits are not easy to define. The legislator must aim to strike a delicate balance between over-deterrence and under-deterrence of CRAs.

To reduce the risk of over-deterrence, suggestions have been made to impose maximum limits on CRAs liability for false ratings,[35] similar to the limitations found, e.g., under product liability law.[36] This proposal certainly has its merits. First, a cap on liability would prevent CRAs from being forced out of the market because of a false rating. Second, a capped liability can also be more easily insured than unlimited liability. Finally, a regulator may likely be able to fine-tune liability to reflect the most appropriate point of balance between under- and over-deterrence.

Yet there are also drawbacks to such a maximum liability. For example, if a uniform ceiling is set, it could under-deter large CRAs, and simultaneously put smaller ones out of business. To avoid this outcome, it has been suggested to vary liability limits

[35] G. Wagner, Die Haftung von Ratingagenturen gegenüber dem Anlegerpublikum, in: Einheit und Vielheit im Unternehmensrecht. Festschrift für U. Blaurock (Tübingen, Mohr Siebeck, 2013), p. 467, 491-493.

[36] See Art. 9(b) Directive Council Directive 85/374/EEC of 25 July 1985 on the approximation of the laws, regulations and administrative provisions of the Member States concerning liability for defective product, OJ L 210, 7.8.1985, p. 29.

depending on the size of the CRA.[37] A moving ceiling, however, may lead to a considerable disadvantage for small CRAs, who may be viewed as being comparatively less trustworthy than larger CRAs with higher potential responsibility. Because of this, a moving ceiling may raise higher barriers to market entry for small CRAs. Moreover, it is questionable from the point of view of the principle of equal treatment why an issuer or investor should have fewer rights against a small CRA than against a big one. The same doubts apply to an alternate proposal that the threshold should be defined as a function of the fees collected by the CRA.[38] In each case, it may be extremely difficult to identify an appropriate limit on liability where the facts of the case are unknown. In particular, a set threshold cannot distinguish between minor and major errors.

In light of these concerns, it makes much more sense to distinguish between different types and qualities of errors. For one, liability should only apply where the rating agency has failed to base its decisions on correct facts or has otherwise failed to correctly apply its own methodology. This restriction is not only necessary because of the protection of free speech and the limits to the judge's handicap with regard to the rating expertise, but also because the CRAs' independent assessment would be inadequately curtailed and competition between different CRAs would be stifled if the courts could *ex post* select one rating to be the correct one. Second, liability should only apply to the most egregious of errors. Otherwise, the risk of over-deterrence may remain prevalent, and investors will most likely tend to mechanistically rely on ratings when they retain the right to seek a remedy against the agency as a safety net.

As will be shown, these two limits are generally respected in comparative law.

8. Comparative Context

When judging whether EU law shall hold rating agencies liable for errors, it is useful to look to foreign jurisdictions for guidance. Many states have already introduced or applied causes of action against CRAs. The large majority of these states are not

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[37] G. Wagner, Die Haftung von Ratingagenturen gegenüber dem Anlegerpublikum, in: Einheit und Vielheit im Unternehmensrecht. Festschrift für U. Blaurock (Tübingen, Mohr Siebeck, 2013), p. 467, 493.

[38] G. Wagner, Die Haftung von Ratingagenturen gegenüber dem Anlegerpublikum, in: Einheit und Vielheit im Unternehmensrecht. Festschrift für U. Blaurock (Tübingen, Mohr Siebeck, 2013), p. 467, 493-494.

ideologically misguided states that flirting with socialist ideas. They are, instead, major capitalist economies.

a) United States: Introduction of Statutory Causes of Action

One example is the United States. U.S. law is of particular importance in the context of the question analysed here because the three largest CRAs – Standard & Poor's, Moody's and Fitch – are each based in New York City. This fact may explain why U.S. courts have hesitated, for a long time, to grant claims against them.[39] Nevertheless, in the wake of the financial crisis and as a reaction to calls for increased responsibility of CRAs, the U.S. legislature has introduced statutory responsibility for ratings. This was accomplished through the Dodd-Frank Act, which amended several U.S. securities laws.

The first of these amendments concerned the Securities Exchange Act of 1934. Under its new section 15E(m), credit ratings are now subject to the same enforcement and penalty provisions that apply to statements made by registered public accounting firms and securities analysts under respective securities laws. Moreover, ratings are no longer considered to be forward looking statements and can therefore not be exempt from liability under section 21E of the Act.[40] Hence, ratings are from now on subject to the catch-all statutory liability of section 10(b) of the Act and Rule 10b-5 promulgated thereunder. According to the Securities Exchange Act, CRA liability is possible under two sets of circumstances.[41] In the first situation, the CRA fails 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. In the second, the CRA fails to obtain reasonable verification of such factual elements from other sources that the credit rating agency considered to be competent and autonomous from the issuer and underwriters. The complaint must state, with particularity, facts that give rise to a strong inference that the CRA knowingly or recklessly failed to adhere to this duty.[42]

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[39] See the discussion on the First Amendment, supra ????.

[40] See section 15E(m)(1) Securities Exchange Act 1934 (15 U.S.C. § 78o-7(m)(1)) as amended by section 933(1) of the Dodd-Frank Act.

[41] Section 21D(b)(2) Securities Exchange Act 1934 (15 U.S.C. § 78u-4(b)(2)) as amended by section 933(2) of the Dodd-Frank Act.

[42] Section 21D(b)(2) Securities Exchange Act 1934 (15 U.S.C. § 78u-4(b)(2)) as amended by section 933(2) of the Dodd-Frank Act.

Another, arguably even more important cause of action against CRAs exists under the Securities Act of 1933. Rule 436(g), promulgated by the Securities and Exchange Commission (SEC), formerly exempted rating agencies from liability under section 11 of the Act by providing that their credit rating shall not be recognized as part of the required registration statement filed with the Commission. The rule was subsequently repealed by the Dodd-Franck Act,[43] meaning that CRAs are no longer shielded from liability under section 11 of the Securities Act of 1933.[44] This liability is particularly attractive for claimants because the pleading standard required is comparatively low. To bring forward a claim, a claimant is only required to show that he purchased a security after the rating had been issued, that the rating agency identified in the complaint is one of the parties enumerated in section 11, and that the rating contained an untrue statement or omission of material fact.[45] There is no need for a claimant to show that he relied on the CRA's statement or that the CRA acted knowingly or recklessly or that the loss was caused by the false rating.[46]

It is true that even under section 11, seeing a claim through to victory is not easy. Rating agencies are not recognized by courts as underwriters in the sense of section 11(a)(5) of the Securities Act of 1933.[47] They can, however, be liable under other aspects of section 11. In particular, they can be identified as experts that are named in the registration statement and therefore be liable under section 11(a)(4) of the Securities Act of 1933. Shortly after the repeal of Rule 436(g), however, the CRAs mounted a rebellion against the application of section 11(a)(4) by refusing to have their ratings included in the registration statements.[48] Such refusal could have completely frozen the market for asset-backed securities, which rely on such ratings. In the face of this threat, the SEC issued a no action-letter in which it declared that it will temporarily withhold enforcement where an asset-backed issuer omits the

[43] See section 939G Dodd-Frank Act. Rule 436(g) was formerly codified as 17 CFR 230.436.
[44] 15 U.S.C. § 77k.
[45] See A.M. Grishteyn, Horseshoes and Hand Grenades: The Dodd-Frank Act's (Almost) Attack on Credit Rating Agencies, 39 Hofstra L. Rev. 937, 959 (2010-2011).
[46] A.M. Grishteyn, Horseshoes and Hand Grenades: The Dodd-Frank Act's (Almost) Attack on Credit Rating Agencies, 39 Hofstra L. Rev. 937, 960 (2010-2011).
[47] In re Lehman Bros. Mortgage-Backed Securities Litigation, 650 F.3d 167, 175-185 (2d Cir. 2011).
[48] B. Brownlow, Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities, 15 N.C. Banking Inst. 111 (2011); B. Haar, Civil Liability of Credit Rating Agencies – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence, available at ssrn.com (last visited 25 November 2013); J. Manns, Downgrating Rating Agency Reform, 81 George Washington University L. Rev. 749, 774 (2013).

ratings disclosure to be included in the registration statement.[49] Later, it extended this relief “pending further notice”.[50]

The CRAs thus have effectively managed to avoid liability under section 11 of the Securities Act 1933. However, there are clear limits. First, the no-action letters by the SEC only concern issuers of ABS. They do not apply, e.g., to issuers of stock and bonds, which are obliged to disclose relevant ratings in the registration statement. Second, the relief granted by the SEC is clearly contrary to the spirit and purpose of the Dodd-Frank Act and may be revoked at any moment in time. Should problems with ratings in the ABS sector occur in the future, the SEC may find it difficult to continue to uphold its relief in the face of mounting political pressure. Thus, there are good reasons to believe that the U.S. may offer prospective claimants fertile ground for filing claims against rating agencies.

b) Australia: Rating Agency Condemned on the Basis of Negligence

Australia offers another guiding example for rating agencies’ civil liability. In fact, it is there that for the first time, as far as it is known, one of the big rating agencies was ordered to pay damages to investors. In *Bathurst Regional Council v Local Government Financial Services Pty Ltd*, the Federal Court for the New South Wales District Registry ordered Standard and Poor’s (S&P) to pay more than $ 30 Mio. in damages.[51] The claimants in this case were local councils who had collectively invested in so-called Constant Proportion Debt Obligations (CPDOs) that S&P had given an “AAA” rating. The instruments were later discovered to be extremely volatile.

The case was very specific in that the rating agency had committed egregious errors. In preparing the rating, it had relied on false information provided by the issuer itself without verifying it independently. Moreover, it had also given the issuer exclusive access to its ratings criteria, thus offering the issuer the opportunity to manipulate its product to secure the highest rating possible.

Judge Jagot based her meticulously drafted 1459 page long decision on the common law tort of negligence, as applied under the Australian Civil Liabilities Act of

[49] SEC, No Action-Letter, Ford Motor Credit Company LLC, 22 July 22 2010.
[50] SEC, No Action-Letter, Ford Motor Credit Company LLC, 23 November 2010.
[51] Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200.

2002, rather than on a statutory cause of action.[52] She held that the rating agency had violated a duty of care that it owed to the investors.[53] It was vital to this ruling that the instrument was customized, that it was only sold to certain investors that were required to only purchase financial instruments that carried a certain rating, and that there was no secondary market for it.

The latter restrictions demonstrate the limits to the efficiency of the common law remedy of negligence when used against CRAs. It is not clear how the Australian courts will rule if a rating agency's mistake concerns a standard product sold to ordinary investors and traded on a secondary market. Moreover, other common law courts may be much more reluctant to recognise a duty of care where privity of contract does not exist.[54]

a) France

Another example of CRA liability comes from the European continent. In 2010, the French legislature introduced an explicit statutory basis for claims against rating agencies.[55] This rule provided for the tortuous and "quasi-tortuous" liability of a CRA towards its clients and third parties if it was found to have violated its duties under EU regulatory law. Under the act, it did not matter whether the violation was done because of gross or simple negligence. In addition, it did not matter whether there was a special duty held by the CRA towards the investor.

When comparing the French rule to the U.S. and Australian law, it is evident that the first is considerably stricter. Should it have stayed and effectively been applied by the French courts, it would have certainly resulted in over-deterrence.

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[52] See Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200, margin no. 2741 et seq.

[53] Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200, margin nos. 2742 et seq.

[54] See on the position of the English courts H. Edwards, CRA 3 and the liability of rating agencies: inconsistent messages from the regulation on credit rating agencies in Europe, Law and Financial Markets Review 2013, p. 186, 189.

[55] See Article L544-5 *Code monétaire et financier*. On this rule, see H. Le Nabasque, Rev. sociétés, 2010. 547; N. Rontchevsky, M. Storck, RTD. com. 2011. 138; Th. Bonneau, JCP E 2010. 1957 ; O. Douvreleur, RTDF 2010/2. 20 ; M. Storck, J. Lasserre Capdeville, LPA, 16 déc. 2010, p. 3 ; S. Yvon, Th. Allain, C. Bérard-Gourisse, Bull. Joly Bourse, 1er nov. 2010, n° 6, p. 492.

III. The European Variant of CRA Liability

1. The Special Situation of a Multi-Level Governance

In Europe, the first question to be answered when determining whether CRAs should be liable or not for false ratings is who should provide for such liability – the Member States or the European Union. This is due to the EU's particular system of multi-level governance, in which different legislators pursue the same objectives and are sometimes competing with each other.[56]

From an economic viewpoint, it seems quite plausible that liability should be provided for on the level of European Union law. It has been shown that the basic goal of such liability is to enforce the regulatory duties under the CRA Regulation.[57] As this Regulation calls for the same enforcement in all Member States, it is necessary that the civil liability regime is also uniform. It is true that traditionally the EU has left the adoption of particular sanctions in the competence of the Member States.[58] But in these cases, civil liability was not itself considered an indispensable avenue of enforcement. It was much more an extra in addition to administrative and criminal sanctions, something that the states could provide for if they wished. With regard to rating agencies, it is different. As has been shown, civil liability is itself to be considered as an indispensible enforcement mechanisms. It can therefore not be left to the discretion of the Member States whether they introduce such a liability, and how strict it is. For very much the same reason, in the United States the matter has not been left to state law, but a uniform cause of action has been introduced into the federal securities laws.

The economic case for a uniform EU regulation of rating agencies' civil liability is therefore quite clear. However, whether the EU has the power for its introduction is a much more complicated question. In accordance with the principle of conferral (Article 5(1) 1 Treaty on the Functioning of the European Union – TFEU), the EU can only act where a special competence has been attributed to it. The amendment of

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[56] On multi-level governance, see e.g. C. Joerges, The Impact of European Integration on Private Law: Reductionist Perceptions, True Conflicts and a New Constitutionalist Perspective, European Law Journal 3 (1997), 378, 384-406; C. Joerges, Interactive Adjudication in the Europeanisation Process? A Demanding Perspective and a Modest Example, European Review of Private Law 8 (2000), 1, 4.

[57] See supra????.

[58] See e.g. the anti-discrimination directives: Directive 2000/43/EC, Article 15; Directive 2000/78/EC, Article 17; Directive 2004/113/EC, Article 14, Directive 2006/54/EC, Article 25.

the CRA Regulation is based on the general competence regarding the Internal Market (Article 114 TFEU).[59] One can certainly say that the activities of rating agencies in the Internal Market are hampered due to diverging rules regarding their liability. Yet in reality, the regulation aims not so much at removing these obstacles by harmonizing the law of the Member States but at maintaining the stability of the internal financial market. This is obviously a legitimate purpose to pursue because a market without stability is not sustainable. It would be good if the ECJ would expressly recognize this connection in its case law on Article 114 TFEU.

The new Regulation must also conform to the principles of subsidiarity and proportionality (Art. 5(1) 2 TFEU). The subsidiarity principle is respected. Given that credit ratings are done not for each market differently, but on a worldwide basis, the enforcement of CRA regulation should be provided for at the highest possible level. In order to accommodate the principle of proportionality, the regulation features particular characteristics, which will be analysed later.

2. The Content of the Rule

New Article 35a(1) of the CRA Regulation reads:

> 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.

When contrasted with the analysis carried out above, a couple of points immediately meet the eye.

First, it is worth noting that the focal point of the provision is not a "false" or "wrong" rating. Rather, the basic condition of liability is the existence of an infringement listed in Annex III. In other words, the claim is triggered by the violation of a specific regulatory duty. This is quite different from a self-standing tort like in classic private law.

It must be noted that the rules the CRAs have to obey go very far. Annex III to the CRA Regulation contains no less than 84 different types of infringements. The total number of duties the rating agencies have to comply with is even higher because some of these infringements concern not a single, but a whole spectrum of duties.

[59] See Preamble Regulation 462/2013.

For instance, No. I 1 of Annex III refers to the infringement of one of the conditions set down in Article 4(3) – which lists eight conditions for the practically enormously important endorsement of a credit rating issued in a third country. It must also be noted that some types of infringement are extremely broadly phrased. Take for instance No. I 42 of Annex III, which reads:

The credit rating agency infringes Article 8(2) by not adopting, implementing or enforcing adequate measures to ensure that the credit ratings and rating outlooks it issues are based on a thorough analysis of all the information that is available to it and that is relevant to its analysis according to the applicable rating methodologies.

Second, it stands out that liability is only incurred if the rating agency acted intentionally or with gross negligence. Mere negligence is not enough. Only a blatant violation on the side of the rating agency will trigger a claim. The policy requirement set out above according to which rating agencies should not be overdeterred or overburdened is thus, in principle, respected, subject of course to the definition of "gross negligence", which depends on national law.[60]

Third, Article 35a CRA Regulation requires that the infringement of any of the regulatory rules referred to must have had "an impact" on a credit rating. In other words, the infringement must have somehow affected the rating. The legislator shied away from stating that the rating must be "wrong" or "false". Such a requirement would have led to difficult problems because it is not easy to determine whether or not a rating actually corresponds to reality, given that it is forward-looking and that there is therefore always an element of subjective assessment involved. However, it follows from the rule that a violation of a regulatory rule does not lead *per se* to the agency's liability, but only where the latter would have rendered a different rating had it not committed the infringement. This excludes most of the numerous infringements of organizational duties listed in Annex III of the Regulation, e.g. the duty to establish an administrative or a supervisory board under Number I 3. The violation of this type of duty in the majority of cases does not change the outcome of a rating. One can therefore expect that disputes on liability will, in practice, mostly turn around the CRA's duty to use all the information that is available to it and that is relevant to its analysis according to its own rating methodology,[61] and its duty to use

[60] See infra ???.
[61] CRA Regulation, Annex III No. I 42.

methodologies that are rigorous, systematic, continuous, and subject to validation based on historical experience, including back-testing.[62]

Fourth, the regulation's claim can be brought by investors or issuers. Given the context of the provision, it is to be assumed that the word "investor" only means persons that invest in the instruments of the issuer that has been rated or in the instruments that have been rated. Other persons, such as shareholders of a bank who has acquired such instruments, do not have standing to bring the claim. Where persons have invested in mutual and other funds that hold such instruments, the "investor" is the fund, and not the individuals who own the fund.

Fifth, the provision presupposes that the investor or issuer has suffered damage and that this damage was caused by the CRA violating its regulatory duties. The violation of such a duty in and by itself, however, never directly results in damage to the investor. Causation always runs via the incorrect rating which either the investor believed in or which led to the heightening of financing costs for the issuer.[63] The causal nexus is thus more complication than the regulation suggests.

Regarding standing, the provision sets out different conditions for investors and issuers. Investors are required to establish that they have reasonably relied on the rating.[64] The definition of the term "reasonably relied" is left to Member State law.[65] Issuers damaged by an incorrect rating, in contrast, generally have standing, except when they themselves have provided information that led to the incorrect rating.[66] The latter exception is self-understood.

As has been shown, CRA liability needs to be carefully designed. This is true not only with regard to the substantive prerequisites, but also with regard to the procedural aspects of the claim. Defining the applicable procedural standard for CRA liability provides a particularly illustrative example of the delicate balance that a legislator must strike between under- and over-deterrence. The EU Commission's proposal for the Amendment Regulation contained a clause that provided that if an investor establishes facts that suggest that a credit rating agency has committed an error, then the credit rating agency must, in turn, prove that it has not committed that

[62] CRA Regulation, Annex III No. I 43.
[63] See Manuel Gietzelt & Johannes Ungerer, Die neue zivilrechtliche Haftung von Ratingagenturen nach Unionsrecht, European Union Private Law Review (Zeitschrift für das Privatrecht der Europäischen Union – GPR), forthcoming.
[64] Art. 36a(1) subpara. 2 CRA Regulation.
[65] See Art. 36a(4) CRA Regulation. On that provision, see infra ????.
[66] Art. 36a(1) subpara. 3 CRA Regulation.

particular infringement.[67] The idea behind this provision was to reduce the burden that a potential claimant may face when trying to establish facts about the failings within the inner workings of a CRA to which he has no access. The result was not a reversal of the burden of proof, as it has sometimes been (falsely) claimed.[68] Instead, the proposal contained a mere relaxation of the claimant's pleading standard. The problem, however, was that it did not list or illustrate the kind of facts an investor had to establish, or explain the degree of certainty that was required. Arguably, it would therefore have sufficed that an investor proves the incorrectness of the rating *ex post* by showing than an excellently rated issuer suffered bankruptcy. In that case, the CRA would then have to show that it did not commit any error. This proposal, as it was written, amounted to a *Probatio diabolica*, a standard of proof that was impossible for the CRAs to meet. In had the potential to invite a wave of litigation related to the difference between a rating and the final outcome of an issuer's condition.

One must therefore call it fortunate that during the legislative process that ensued, the clause was considerably amended. The amended version that has now come into force provides that it shall be the responsibility of the claimant to present accurate and detailed information that shows the credit rating agency has committed an infringement of the Regulation.[69] The level of accuracy and detail required has been left to each national court to decide.[70] This can be no surprise, as it is always the court that interprets and applies legal requirements. But in doing so, the CRA Regulation provides that the court shall take "into consideration that the investor or issuer may not have access to information which is purely within the sphere of the credit rating agency". The problem concerning access to evidence under the initial drafting has therefore been limited to its correct core. The balance between under- and over-deterrence is, thus, maintained, at least on this point.

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[67] European Commission, Proposal for a Regulation of the European Parliament and the Council amending Regulation (EC) No 1060/2009 on credit rating agencies, COM(2011) 747 final, p. 33, Art. 35a(4).
[68] H. Edwards, CRA 3 and the liability of rating agencies: inconsistent messages from the regulation on credit rating agencies in Europe, Law and Financial Markets Review 2013, p. 186, 188.
[69] Art. 35(4) subpara. 1 CRA Regulation.
[70] Art. 35(4) subpara. 2 CRA Regulation.