



NEDERLANDSE VERENIGING VOOR RECHTSVERGELIJKING  
NETHERLANDS COMPARATIVE LAW ASSOCIATION

## **Control and Responsibility of Credit Rating Agencies\***

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### 1. Introduction

“Credit Rating” is the standardised evaluation of the future capability of a debtor to satisfy its liabilities vis-à-vis its creditors. This evaluation is undertaken by “Credit Rating Agencies” (CRA). They make a prognosis on the probability of a debtor, or a title to a debt, failing – and can make errors in this regard. If the erroneous prognosis or the delayed adjustment of the original evaluation is accompanied by considerable failures, such as in the cases of Enron, Worldcom or Parmalat, it comes as no surprise that the activities of CRAs have now been thrown into the spotlight of public attention.

Credit Rating is now attracting worldwide legal interest. Both in all large national economies and in international organisations, the liability risks incurred by CRAs are being examined and legal regulation of their activities, as well as legal supervision, is under contemplation. This justifies a comparative examination within the scope of the XVII<sup>th</sup> Congress of the International Academy of Comparative Law.

This general report is based on a survey containing 81 questions from 11 fields of interest that was sent to the national committees of the Academy. Important topics included:

- the supervision of CRAs and national requirements,
- the rights and obligations of CRAs,
- the assurance of quality and correctness of ratings,
- civil liability,
- the special problem of non-commissioned ratings, and finally

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\* Session III.A.1. L'interprétation des textes juridiques rédigés dans plus d'une langue. National reports received from: Belgium, E. Wymeersch & M. Kruithof; Canada, S. Rousseau; France, Y. Chaput; Greece, C. Gortsos; Italy, S. Sica; the Netherlands, H. A. de Savornin Lohman & M. G. van 't Westeinde; Poland, M. Lemonnier; Switzerland, R. T. Trindade & M. Senn; US, A. R. Pinto.

- whether and, if so, how the commissioning of external ratings can be used as a supervisory instrument.

National reports were received from nine countries, namely from Belgium, Canada, France, Greece, Italy, the Netherlands, Poland, Switzerland, and the USA. These national reports<sup>1</sup> constitute the basis for the general report, in which the situation in Germany is also considered on the basis of local knowledge.

## 2. Basic Principles

### 2.1. Subject-Matter of the Study

#### 2.1.1. Explanation of Terminology

‘A credit rating is an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system.’<sup>2</sup> Ratings are standardised expressions of opinion on the future capability, legal obligation and willingness of an issuer to fulfil payments of interest and to satisfy bonds on time and in their entirety.<sup>3</sup> A differentiation is made between internal ratings by banks and – this is the subject-matter of this study – external ones undertaken by independent private enterprises, the Credit Rating Agencies. The agencies do not make any purchase recommendations, but rather express their opinion on the creditworthiness of the debtor and the risk of the non-repayment of the loans granted. They do this by applying standardised measures, and evaluate special capital market products or the issuers themselves.<sup>4</sup> In this regard, the rating agencies limit themselves not only to businesses, but also evaluate public bodies and states.

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<sup>1</sup> Those National Reports that have not yet been published will be cited mentioning the *National Reporter* and the country as well as the exact reference (if possible).

<sup>2</sup> Committee of European Securities Regulators (CESR), Technical Advice to the European Commission on possible measures concerning credit rating agencies, March 2005, para. 35.

<sup>3</sup> Cf. A. C. Peters, *Die Haftung and Regulierung von Ratingagenturen* 28 (2001).

<sup>4</sup> B. Großfeld, *Globales Rating*, 101 *Zeitschrift für Vergleichende Rechtswissenschaft (ZvglRWiss)* 387, p. 391 (2002).

## 2.1.2. Evaluation Methodology

In their ratings, rating agencies give grades for creditworthiness which range from ‘AAA’ – for the highest level of creditworthiness – to ‘D’ – for insolvency.<sup>5</sup> According to their grade, the objects evaluated are then classified as ‘investment grade’ or ‘speculative grade’. The precise classification when giving a grade is defined by each rating agency individually.<sup>6</sup>

The agencies reach their results by analysing various specific pieces of information. Initially, quantitative data, such as sales, cash flow, the proportion of equity capital etc., but also trade and country risks, find their way into the evaluation.<sup>7</sup> In addition, qualitative criteria are also usually considered, which are consciously made the basis of a subjective appraisal. For example, the following aspects are cited: firm culture and internal organisation, communication, and management know-how.<sup>8</sup> In order to evaluate the qualitative criteria, in the usual case of so-called interactive ratings, contact is established with the company heads.

## 2.1.3. Rating Process

### 2.1.3.1 Solicited rating

In the usual case, the issuer commissions and pays for the rating itself, as it can count on a reduction in financing costs if a good evaluation of creditworthiness is obtained. A short introductory meeting follows, at which the issuer is informed about the course of the rating process and is given an idea of what information is significant for the analysis process.<sup>9</sup> Pursuant thereto, a rating committee suited to the industry and the type of issuer is constituted, which is comprised of employees from various departments under the chairmanship of a Lead Analyst. The analysts then begin to collect the necessary information; with the help of various databases, all publicly available material is collected. Furthermore, considerable significance is attached to the cooperation between the rating agency and the commissioning party. The main meeting with the management usually takes place at the issuer and can, and often does, last for several days. By conversing with members of the executive, the analysts have

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<sup>5</sup> Other scales are usually applied for short-dated ratings with less than one year of duration, *cf.* J. Berblinger, *Marktakzeptanz des Ratings durch Qualität*, in H. E. Büschgen & O. Everling, *Handbuch Rating* 21 (1996), p. 33; W. Meyer-Parpart, *Ratingkriterien für Unternehmen*, in H. E. Büschgen & O. Everling, *Handbuch Rating* 111 (1996), p. 157.

<sup>6</sup> J. Witte & B. Hrubesch, *Rechtsschutzmöglichkeiten beim Unternehmens-Rating*, 2004 *Zeitschrift für Wirtschaftsrecht und Insolvenzpraxis* (ZIP) 1346, p. 1347.

<sup>7</sup> J. Berblinger, *supra* note 5, at 64 *et seq.*; *see further* concerning the Top-Down Approach *infra* note. 38.

<sup>8</sup> S. Kischewski & M. Müller, *Unternehmensfinanzierung im Umbruch – Auswirkungen von Basel II und Unternehmensrating auf die Finanzierung deutscher Unternehmen*, 2005 *Arbeitsrecht im Betrieb* (AiB) 40.

<sup>9</sup> Berblinger, *supra* note 5, at 61.

the opportunity to ask specific questions and to obtain an insight into the internal strategies and perspectives,<sup>10</sup> which, as qualitative factors, are taken into account in the subsequent evaluation.

Following the collection of information, the data obtained is analysed. The weight to be attributed to the decision criteria is determined by each rating agency individually. The analysts present their evaluation proposal to the rating committee, which subsequently decides upon the grade to be given.<sup>11</sup>

Before publishing its appraisal, the rating agency again establishes contact with the issuer and informs it of the result and the fundamental reasons for the decision. In this way, the issuer is given the possibility of taking a position; in addition, it is free to have a positive influence on the rating result by submitting additional information.<sup>12</sup> In some cases, the publication of the rating result is made entirely dependent on the consent of the issuer.<sup>13</sup> Whilst the rating grade is usually published free of charge on the homepage of the agency, paying subscribers to the rating journal receive more detailed reports.

If the rating concerned is not a so-called ‘point in time rating’, once published, the rating is subject to further supervision by a so-called “Surveillance Team” and will be reviewed and, if necessary, revised, at least once a year. If short- or longer-term changes are expected, the rating will be placed on a “watch list” and a non-binding tendency for the rating will be made public, in order to give investors plenty of notice.<sup>14</sup>

#### 2.1.3.2. Unsolicited rating

The usual case of solicited ratings just described can be distinguished from unsolicited ratings, which are compiled at the rating agency’s own initiative or on the instructions of a third party. Without the cooperation of the issuer, the rating agency usually only has access to the publicly available company data; qualitative criteria remain unconsidered. The agencies usually signpost the different sources of data by adding a ‘PI’ for public information or a ‘q’ for quantitative rating.

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<sup>10</sup> Peters, *supra* note 3, p. 31.

<sup>11</sup> Peters, *supra* note 3, p. 31.

<sup>12</sup> E. Vetter, *Rechtsprobleme des externen Rechts*, 2004 Wertpapier-Mitteilungen (WM) 1701, at 1702.

<sup>13</sup> Peters, *supra* note 3, p. 34.

<sup>14</sup> Vetter, *supra* note 12, at 1702.

## 2.2. The Rating Market

On the part of American companies, the demand for ratings is traditionally high, whilst in Europe, owing to the bank-oriented financing behaviour,<sup>15</sup> such a demand was limited and did not start to increase until the last 30 years. Marked differences can still be discerned between the individual European states.

With respect to the supply side, the rating market is characterised by an oligopoly. Even though the number of involved agencies may amount to more than 100 worldwide,<sup>16</sup> three large international agencies share almost the entire market: the American firms Standard and Poor's (S & P) and Moody's jointly have approximately 80% of the market share; the British agency Fitch, a 100% subsidiary of the French Fimalac Group, holds a further 15%. Therefore, in reality, the appropriate term should be an "American duopoly". Also worth mentioning on an international scale are the insurance raters A. M. Best and the Canadian Dominion Bond Rating Services.

It is obviously difficult for national CRAs to establish themselves alongside these international agencies. In this regard, there are a number of examples from the national reports: in the Netherlands,<sup>17</sup> Belgium<sup>18</sup> and Greece,<sup>19</sup> there are no local agencies; in Poland,<sup>20</sup> the agency CERA was founded in 1995, but is now, however, under the control of Fitch. Nonetheless, in Switzerland<sup>21</sup> an agency called "ComRating" has been able to establish itself on the local market. However, this was only possible through specialising in the evaluation of public borrowers. This example is in conformity with the conclusion that an entry into the market is only possible in geographical or sector-specific niches.<sup>22</sup> A natural hurdle for more competition is that issuers commission primarily those agencies that are held in high esteem by investors; however, this, in turn, is significantly determined by the track record<sup>23</sup> of the

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<sup>15</sup> Kischewski & Müller, *supra* note 8, at 41; M. Habersack, *Rechtsfragen des Emittenten-Ratings*, 169 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR)* 185, at 186 (2005); *see* in the National Reports: E. Wymeersch & M. Kruithof, *Regulation and Liability of Credit Rating Agencies under Belgian Law*, in *The Belgian reports at the Congress of Utrecht of the International Academy of Comparative Law* (2006), p. 351-419, at 355 *et seq.*; S. Sica, *National Report Italy (I)*, p. 6.

<sup>16</sup> Securities and Exchange Commission (SEC), Definition of Nationally Recognized Statistical Rating Organization, 17 CFR Part 240, Release Nos. 33-8570, 34-51572, at 68 (*see further infra* note 156).

<sup>17</sup> H. A. de Savornin Lohman & M. G. van 't Westeinde, *National Report the Netherlands (NL)*, 'Introduction', p. 1.

<sup>18</sup> Wymeersch & Kruithof (BEL), *supra* note 15, at 356.

<sup>19</sup> C. Gortsos, *National Report Greece (GR)*, n. 3.

<sup>20</sup> M. Lemonnier, *National Report Poland (POL)*, III. 1, p. 14.

<sup>21</sup> R. T. Trindade & M. Senn, *Control and Responsibility of Rating Agencies in Switzerland*, in *Rapports Suisses présentés au XVIIe Congrès international de droit comparé* (2006), p. 137-161, at 138.

<sup>22</sup> Trindade & Senn represent a more positive view according to Switzerland, *see* Trindade & Senn, *supra* note 21, at 146.

<sup>23</sup> G. Deipenbrock, *Aktuelle Rechtsfragen zur Regulierung des Ratingwesens*, 2005 *WM* 261, at 262.

agency. New entrants, who obviously cannot present any historical figures, tend to indicate a lack of reputation that, in turn, represents a large competitive disadvantage. Therefore, if only for factual reasons, the oligopoly appears to be here to stay.

The described lack of competition appears to be ridden with problems.<sup>24</sup> On the one hand, it gives rise to the fear that the dominant agencies are in a position to abuse this lack of competition by increasing their prices.<sup>25</sup> On the other hand, however, it also raises concerns with respect to the quality of the ratings, as the dominant agencies do not have to fear any significant qualitative cut-throat competition, with the consequence that the temptation exists to keep their resource input down.<sup>26</sup> Ultimately, their market power could even allow the large CRAs to make the tender of the necessary ratings for the issuer dependent on the issuer making use of ‘auxiliary services’ of the agency in question.<sup>27</sup> In this way, further growth of the rating agencies at the cost of the companies would result. In this context, it will be interesting to observe how the revenue volume for auxiliary services will develop in the future in relation to the revenue for the compilation of ratings.<sup>28</sup> In the Italian report,<sup>29</sup> the additional fear is expressed that the supremacy of the American CRAs would mean a competitive advantage for the American companies – be it due to “local team” support or due to a lack of understanding of foreign economies and legal systems. The CRAs themselves, by way of contrast, always emphasise that their evaluation approaches are free from influence by any factors based on the location and the legal system in place. Finally, the concentration of supply on selected large agencies could hinder the access of small and medium-sized companies to an affordable rating.<sup>30</sup>

## 2.3. Significance and Application of External Ratings

### 2.3.1. Reduction in Information Asymmetries on the Capital Markets

The fields of application for ratings have continued to grow over the years. In the beginning, the activity merely served to reduce information asymmetries on the market. In the meantime,

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<sup>24</sup> According to Trindade & Senn, there are no competition deficiencies in Switzerland; *see* Trindade & Senn, *supra* note 21, at 146.

<sup>25</sup> A. R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, in *American Law in the 21st Century: U.S. National Reports to the XVII<sup>th</sup> International Congress of Comparative Law* (2006), p. 341-356, at 344.

<sup>26</sup> S. Emmenegger, *Die Regulierung von Rating-Agenturen*, 2006 *Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht (SZW)* 32, at 35; S. Rousseau, *National Report Canada (CAN)*, II. A. 1. a), p. 13.

<sup>27</sup> Pinto (US), *supra* note 25, p. 341 at 344.

<sup>28</sup> Based on the prognosis that the returns of additional services will greatly increase in relation to the income from rating activities: C. Walkner, *Issues in corporate governance*, in *European Economy, Economic Papers No. 200*, Issues in corporate governance, March 2004, p. 43.

<sup>29</sup> Sica (I), *supra* note 15, p. 3.

<sup>30</sup> Lemonnier (POL), *supra* note 20, III. 1.1, p. 14; dissenting – Gortsos (GR), *supra* note 19, n. 21, assuming that the poor distribution of ratings is based on a diminished necessity.

the significance of a good rating as advertising material for the issuing company, for the purposes of persuading potential investors of its creditworthiness, has been discovered. Accordingly, today it is the evaluated companies themselves that pay for a rating.<sup>31</sup>

The following, in particular, count among those who use ratings as a pure source of information:<sup>32</sup>

- issuers,
- purchasers of bonds,
- institutional investors who often, in accordance with internal guidelines, only invest in investment grade,
- share purchasers and
- securities advisors in conjunction with their own analyses.

Consequently, the rating agencies' considerable potential for power results from the prevalent use of their ratings and the acceptance by the market: they offer the issuing company the opportunity to use and communicate non-public information externally, without disclosing its precise content. They save the investors from undertaking their own costly and time-consuming research to determine the creditworthiness of the issuer.

In light of the increasing lack of transparency of the capital market in the course of globalisation, and the establishment of new complex financing instruments – also, notably, in Europe – ratings have attained increased significance. These developments allow the need for reliable information provided by an independent intermediary, such as is promised by rating agencies, to grow; the worldwide boom currently experienced in the rating trade must, however, also be credited to the expansion of the market usages in the leading finance and business location, the USA, where wide circles have long been familiar with the concept of ratings.<sup>33</sup> Accordingly, the ability to provide a rating has also developed into a factual entry requirement in Europe and Asia, not only to the capital market, but also to the money market.<sup>34</sup>

Therefore, the appraisal by the rating agency has existential significance for the companies evaluated. In this way, a good rating or an upgrade can fundamentally reduce capital acquisition costs; according to data from Standard and Poor's, in 2004, the advancement from the category "BB" to investment grade "BBB" resulted in an almost 50% reduction in loan costs.<sup>35</sup> However, the cost-increasing effect of even a slight downgrade is even stronger.<sup>36</sup>

<sup>31</sup> Autorité des marchés financiers (AMF), Rapport 2004 de l'AMF sur les Agences de Notations, p. 18.

<sup>32</sup> The International Organization of Securities Commissions (IOSCO), Report on the Activities of Credit Rating Agencies, September 2003, p. 6 *et seq.*

<sup>33</sup> O. Everling, in H. E. Büschgen & O. Everling *supra* note 5, p. 4 at 11.

<sup>34</sup> Deipenbrock, *supra* note 23, 261.

<sup>35</sup> Insight from S & P, Making the Investment Grade, BusinessWeek Online of 03/21/2006; more critical concerning the investment grade limit is Krämer, cited by M. Voges & M. Rehberg, *Internes und externes Rating: Aktuelle Entwicklungen im Recht der Kreditsicherheiten – national und international*, 2004 WM 1605, at 1606.

<sup>36</sup> This asymmetry has been proven in numerous studies, *see* for further references Wymeersch & Kruithof (BEL), *supra* note 15, at 404 n. 223.

In the insurance branch as well, a good rating is deemed to be an expression of the financial power of the insurer and is now a must for a successful public image regarding customers and investors. In addition, the rating can also have indirect consequences for the chart development on the share market.<sup>37</sup>

In this way, the evaluation of state entities can have even greater consequences. A downgrade of Germany from the top grade of Triple-A, as predicted by S & P in the event that the reform “blockade” cannot be carried off, would burden the public budget with an annual amount going into double-figures of millions. However, what would be much more damaging would be the loss of image thereby incurred and the long-term effects on domestic companies, which would also have to reckon with a downgrade of their ratings.<sup>38</sup>

### 2.3.2. Rating Triggers

Furthermore, in contractual practice, numerous ‘rating triggers’ can be found. These are contractual clauses which link a change in rating with civil law consequences in the form of conditions precedent or subsequent, or independent rights to alter or terminate a legal transaction (*Gestaltungsrechten*).<sup>39</sup> ‘Rating triggers’ can often be found in long-term loan agreements in the general form that the amount of the interest rate is variably oriented on the current rating of the debtor,<sup>40</sup> or that a downgrade in the rating gives rise to a claim of the creditor for further securities.

In addition to the collapse of Enron, the insolvency of Pacific Gas and Electric<sup>41</sup> also offers an example of how the use of contractual rating reservations can magnify the effects of rating changes and, thereby, can considerably increase the volatility of the markets. This raises the question of the admissibility and transparency of such clauses.<sup>42</sup> However, this question does not actually concern the activities of CRAs.

### 2.3.3. Legislative Use

In addition to the increasing factual significance of credit ratings, a supervisory law aspect must also be considered. The leader in this field was the USA, which, in 1931, had already placed an obligation on banks and other financial institutions to partially depreciate those

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<sup>37</sup> Autorité des marchés financiers (AMF), L’impact de la notation, available at: [http://www.amf-france.org/documents/general/6477\\_1.pdf](http://www.amf-france.org/documents/general/6477_1.pdf) (update of 04/08/2006).

<sup>38</sup> Following the Top-Down Approach, a company rating cannot turn out higher than the rating of the country in which it is located, *cf.* Witte & Hrubesch, *supra* note 6, at 1348; Berblinger, *supra* note 5, at 64.

<sup>39</sup> Habersack, *supra* note 15, at 188 *et seq.* *cf.* concerning current trigger contents Committee of European Securities Regulators (CESR), Consultation Paper, November 2004, Annex E, p. 83.

<sup>40</sup> Witte & Hrubesch, *supra* note 6, at 1348.

<sup>41</sup> See CESR, *supra* note 39, Annex E, p. 81.

<sup>42</sup> Habersack, *supra* note 15, at 208 *et seq.*

bonds with an evaluation below the ‘investment grade’ in order to ensure adequate capital; as of 1936, they had to do away with them altogether.<sup>43</sup> This paved the way for a similar initiative in numerous other federal and local state laws.

In the meantime, ratings have developed into a fixed determinant in many domestic legal systems,<sup>44</sup> both under bank supervisory laws as well as under securities and insurance laws: ratings are often used to categorise certain securities as ‘investment grade’ or ‘speculative grade’, which is then used to regulate the banking and investment branches: in this way, in Canada, Belgium and Poland, among other countries, securities are identified as those in which certain investors can invest without obtaining prior approval, or even as those in which investment can be made at all.<sup>45</sup> The suppliers of ‘investment grade’ securities profit from preferential rules which take the lower risk potential into account.<sup>46</sup> In France<sup>47</sup> and Greece,<sup>48</sup> a rating must be provided in order to place certain financial titles as well. In Italy, securities must be rated externally if they are intended to be offered to non-commercial investors.<sup>49</sup> In banking law, reduced deposit obligations exist for “qualified securities”, which have been categorised as ‘investment grade’ by two recognised CRAs.<sup>50</sup> Above all, it is the guidelines of the stock exchanges that require a rating, or at least its publication if one exists.<sup>51</sup>

These developments show that ratings have now established themselves internationally as instruments to regulate credit and market risks. In recent times, the Revised Framework on Capital Standards for banks by the Basel Committee on Banking Supervision (Basel II) has provided a push in that direction: the standard approach described there provides for the utilisation of external ratings in determining the weight of the risk and, thereby, the scope of the necessary equity capital securitisation in the credit tender.<sup>52</sup> Thereby, the significance of external ratings for the financial markets is decisively reinforced.

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<sup>43</sup> Emmenegger, *supra* note 26, at 34.

<sup>44</sup> To date, there is no regulatory issue concerning external rating in Germany. This will change with the conversion to Basel resolutions (*see infra* note. 52).

<sup>45</sup> Rousseau (CAN), *supra* note 26, I. C., p. 10; Lemonnier (POL), *supra* note 20, II. 2. (p. 11); in Belgium, admissible investments by the public Belgian National Pensions Service in private bonds are based on their rating, *cf.* Wymeersch & Kruithof (BEL), *supra* note 15, at 368.

<sup>46</sup> Rousseau (CAN), *supra* note 26, I. C., p. 10. In the Netherlands, companies rated by a CRA approved by the Dutch Central Bank gain the status of a „professional market party“, which exonerates its credit users from certain approval requirements, *cf.* De Savornin Lohman & Van ‘t Westeinde (NL), *supra* note 17, p. 3 n. 7.

<sup>47</sup> Y. Chaput (F), *Contrôle et responsabilité de la notation financière: les agences de rating en droit français*, 2006 *Revue internationale de droit comparé* 493-502, at 499 *et seq.*; AMF, *supra* note 31, at 39.

<sup>48</sup> Gortsos (GR), *supra* note 19, n. 5.

<sup>49</sup> Sica (I), *supra* note 15, p. 9 *et seq.*

<sup>50</sup> Sica (I), *supra* note 15, p. 10.

<sup>51</sup> *E.g.* Euronext, *cf.* Wymeersch & Kruithof (BEL), *supra* note 15, at 360 *et seq.*; and the Borsa Italiana, *cf.* Sica (I), *supra* note 15, at 10. Lemonnier (POL), *supra* note 20, III. 1.3, at 16, states of upcoming internal stock market rules in Poland. Strictly speaking, these are, of course, not governmental laws.

<sup>52</sup> *See* Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards – A Revised Framework*, June 2004, n. 50 *et seq.*, 90 *et seq.* Regarding the conversion *see infra* note 74.

## 2.4. Crisis of Confidence

Consequently, the activities of credit rating agencies are not only attributed large factual, but also, increasingly, legal significance. This is accompanied by a – not to be underestimated – position of power; a reliable appraisal by the agencies of investment risks with a precise determination of creditworthiness has developed into an essential basis for the efficiency of the financial markets, which are becoming increasingly more global. However, credit ratings can only fulfil this task if the reliability and quality of the credit rating agencies involved is beyond doubt.

However, in recent times, this is precisely what has been called into question. The carelessness of the CRAs involved in the case of energy giant Enron caused a ripple effect.<sup>53</sup> It has not been forgotten that, in the collapse of the Parmalat Group, the ‘investment grade’ status was not revoked until the last minute. In the past, it was spectacular cases, such as the failure of the Penn Central Shares in the USA,<sup>54</sup> or the Cirio scandal in Italy,<sup>55</sup> that increased the significance of credit rating; the recent scandals have brought about its crisis.

## 3. Regulation

### 3.1. Current Legal Framework for Credit Rating

This raises the question of which legal framework exists for the activities of rating agencies. Which supervisory law requirements are they subject to in the various legal systems and which liability risks are they exposed to?

#### 3.1.1. State Regulation

##### 3.1.1.1 Approval requirements

All the legal systems examined have a lack of comprehensive regulation of the activities of CRAs in common. In addition, there is no compulsory registration in any country; similarly, the ability to act as a rating agency is not dependent on state approval anywhere.

In the European Community (EC), since 2006, the ability to act as a securities advisor is subject to a uniform approval requirement.<sup>56</sup> A securities advisor is defined as someone

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<sup>53</sup> Concerning the developments related to the Sarbanes-Oxley Act 2002, *see* Pinto (US), *supra* note 25, at 348 *et seq.*

<sup>54</sup> Pinto (US), *supra* note 25, at 347.

<sup>55</sup> Sica (I), *supra* note 15, at 6.

<sup>56</sup> EC Directive 2004/39/EC on markets for financial instruments, concerning the modification of Directives 85/611/EEG and 93/6/EEG of the European Council and Directive 2000/12/EG of the European Parliament and the Council and concerning the repeal of Directive 93/22/EEG of the Council, ABl. 2004 L 145/1. The conversion period was originally up to 04/30/2006, but it ought to be extended to 10/30/2006, KOM(2005) 253.

who places financial instruments or gives investment advice. Rating agencies would only fall within the scope of application of this rule if they were to make recommendations on purchases or sales. However, this is precisely what CRAs do not want.<sup>57</sup> The European Parliament and Advisory Council are of the same view,<sup>58</sup> which is why there is currently no approval procedure planned for CRAs.

### 3.1.1.2. Recognition procedure

#### 3.1.1.2.1 NRSRO concept in the USA

Even if an approval requirement does not exist in any of the countries compared, most are still familiar with a recognition procedure. The leader in this field was the USA. The Securities and Exchange Commission (SEC) had already coined the term “Nationally recognized statistical rating organization” (NRSRO) for the purposes of the legal appraisal of ratings within the scope of capital adequacy in 1975.<sup>59</sup> Such an organisation received a so-called ‘no-action letter’, which stated that the state authorities would not raise any objections if banks were to present ratings from such a recognised agency under the ‘net capital rule’. The NRSRO concept has since been continually applied where rating appraisals have been used by the American legislature. Even abroad, the recognition as NRSRO can have an effect.<sup>60</sup> Currently, there are five CRAs that have been recognised in this way: Standard & Poor’s, Moody’s, Fitch, Dominion Bond Rating Service and, since 2005, the insurance rater A.M. Best. Despite its considerable use, the term is yet to be officially defined. However, several criteria can be discerned from the practices of the SEC, the most significant of which is the widespread acceptance by the most important users on the market of NRSROs as publishers of credible and reliable ratings.<sup>61</sup>

Even if the recognition as NRSRO is voluntary and does not constitute any legal access requirement to the rating market, it has nevertheless been shown that the concept presents itself as a *de facto* hurdle to entering the market.<sup>62</sup> Above all, this is due to the fact that, here,

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<sup>57</sup> Corresponding indications are preceded by the CRAs to their definitions of rating symbols; e.g. Moody’s, *Rating Symbols and Definitions*, available at: [www.moody.com](http://www.moody.com) (update of 04/08/2006).

<sup>58</sup> Cf. reason 10 of EC Directive 2003/125/EC about the implementation of Market Abuse Directive, ABJ. 2003 L 339/73. Dissenting Australian Securities and Investments Commission (ASIC), cf. press release of 06/09/2005: *IR 05-30 ASIC seeks industry comment on proposed licensing exemption for credit rating agencies*, available at: [www.asic.gov.au](http://www.asic.gov.au) (update of 04/08/2006).

<sup>59</sup> See also Pinto (US), *supra* note 25, at 346 *et seq.*, dated on the first application in 1973; see in contrast SEC, *supra* note 16, at 5 n. 2, available at: [www.sec.gov/rules/proposed/33-8570.pdf](http://www.sec.gov/rules/proposed/33-8570.pdf) (update of 04/08/2006).

<sup>60</sup> Further references at SEC, *supra* note 16, at 8 in n. 15.

<sup>61</sup> Rousseau (CAN), *supra* note 26, I. C., p. 11.

<sup>62</sup> See Emmenegger, *supra* note 26, at 38; Peters, *supra* note 3, at 146 for further sources.

market acceptance is elevated to a criterion of recognition. Last but not least, the fact that many regulations even go so far as to require evaluation by two NRSROs has promoted the duopoly of S & P and Moody's.<sup>63</sup>

Nonetheless, in its definition proposal for NRSROs released in 2005, the SEC did not believe it could do without market acceptance as one of the three compliance criteria.<sup>64</sup> The SEC rejected the proposal that agencies which may comply with the factual requirements, but which are, however, lacking acceptance on the market, should be granted a type of preliminary NRSRO status; however, it entertained the possibility of recognition being limited geographically or by trade sector.<sup>65</sup>

### 3.1.1.2.2. Expansion

With the increasing use of ratings as instruments of financial regulation outside the USA, the concept of the recognition of rating agencies for these purposes has also spread. As already mentioned, up until now, direct reference was made to the American NRSRO status. Furthermore, Canada, the Netherlands, France, Italy, Switzerland, Belgium and Poland all have their own definitions of "recognised" CRAs. Common to all legal systems cited is that recognition does not constitute a licence to act at all, but rather, only has the consequence that the rating products in question can be utilised for supervisory law purposes.

In Canada,<sup>66</sup> the recognised CRAs are only stated in the relevant statutes by a "rudimentary listing", without specifically addressing the criteria actually needed to attain the status. The circle of CRAs that are 'recognized' or 'approved' is usually larger than in the USA. In Poland,<sup>67</sup> only ratings from Moody's and S & P may be applied to legislative use. In the Netherlands,<sup>68</sup> recognition is by the Dutch Central Bank; in France,<sup>69</sup> the Minister for Economic Affairs keeps a list of recognised agencies. In accordance with the US example, this list is limited to the larger agencies. In Switzerland,<sup>70</sup> the Federal Banking Commission keeps such a list internally; the CRAs on this list are selected according to how well they are known and their international presence. It is worth noting that the recognition practice there can be reversed at any time; consequently, inclusion on the list does not constitute any assured status. Recognition in Italy<sup>71</sup> is by the national securities supervisory authority CONSOB, which has formulated criteria regarding organisation, qualification of analysts and compliance with

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<sup>63</sup> Everling, *supra* note 33, at 17.

<sup>64</sup> Pinto (US), *supra* note 25, at 348 *et seq.*

<sup>65</sup> SEC, *supra* note 16, at 30 *et seq.* in n. 67, at 52 *et seq.* in n. 112.

<sup>66</sup> Rousseau (CAN), *supra* note 26, I. C., p. 10.

<sup>67</sup> Lemonnier (POL), *supra* note 20, II. 2., p. 11.

<sup>68</sup> De Savornin Lohman & Van 't Westeinde (NL), *supra* note 17, 'Regulatory Aspects – General' p. 3, n. 7.

<sup>69</sup> Chaput (F), *supra* note 47, at 499 *et seq.*; AMF, *supra* note 31, at 39.

<sup>70</sup> Trindade & Senn (CH), *supra* note 21, at 143.

<sup>71</sup> Sica (I), *supra* note 15, at 10.

professional standards. However, for the purposes of bank supervision, a separate list, which is not further explained, is kept as an attachment to the “Instructions for Bank Supervision” of the national bank. The situation in Belgium<sup>72</sup> is also characterised by a lack of uniformity: for the purposes of the minimum capital rules under Basel I, there is a non-explained list kept by the general financial supervisory authority that contains the big three. In the case of mandatory evaluation of structured securities, the individual contracts between CRA and issuer will be approved on condition that the agency offers a guarantee of its professionalism based on its means and resources. In contrast, for other purposes, “internationally recognised” agencies should be accepted, without it being clear who decides this, and on what basis, in the individual case. The recognised CRAs have not yet been determined in Greece,<sup>73</sup> either.

### 3.1.1.2.3 External Credit Assessment Institution

It is fair to say that a recognition procedure can be found where rating appraisals have an impact on legal regulations. It thus becomes clear why such a recognition procedure was lacking in Germany up until now, as, there, rating appraisals do not yet play any role for regulation. However, this will change with the implementation of Basel II.<sup>74</sup> As already mentioned, within the scope of the standard approach, reference will be made to external ratings by so-called External Credit Assessment Institutions (ECAI).<sup>75</sup> These must complete a ‘recognition process’ that is supposed to provide the assurance of objectivity, independence, the publication of results and transparency of methods, sufficient availability of resources and the credibility of the agency. Above all, the evaluation of credibility should also be based upon a high market share of rating appraisals.<sup>76</sup> Switzerland is creating a formal recognition process,<sup>77</sup> a ‘joint assessment process’<sup>78</sup> is planned for the EC, which does, however, ultimately leave the decision-making competence to the Member States. In contrast, the USA is not implementing the standard approach.<sup>79</sup>

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<sup>72</sup> Wymeersch & Kruithof (BEL), *supra* note 15, at 362 *et seq.*

<sup>73</sup> Gortsos (GR), *supra* note 19, n. 5.

<sup>74</sup> Concerning the conversion in the EC *cf.* [http://europa.eu.int/comm/internal\\_market/bank/regcapital/index\\_de.htm](http://europa.eu.int/comm/internal_market/bank/regcapital/index_de.htm); concerning the German conversion proposal in the draft insolvency statute of 05/17/2005 *see* Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) of 12/20/2005, [http://www.bafin.de/schreiben/89\\_2005/051220\\_2.htm](http://www.bafin.de/schreiben/89_2005/051220_2.htm) (update of 04/08/2006).

<sup>75</sup> Basel Committee on Banking Supervision, *supra* note 52, n. 90 *et seq.*

<sup>76</sup> *Cf. also* Proposal for a revised form of Banking Directive of 07/14/2004, KOM(2004) 486 final, affix VI, part 2, chapter 2.1; *see* for critical remarks the statement of the European Central Bank, ABl. 2005 C 52/37 Note 35.

<sup>77</sup> Trindade & Senn (CH), *supra* note 21, at 143.

<sup>78</sup> Committee of European Banking Supervisors (CEBS), Guidelines on the recognition of External Credit Assessment Institutions, 20 Jan 2006, available at: <http://www.cebs.org/pdfs/GL07.pdf> (update of 04/08/2006).

<sup>79</sup> Emmenegger, *supra* note 26, at 34 n. 14.

#### 3.1.1.2.4 Conclusion

Whilst, in some legal systems, transparent requirements for attaining recognition status have been published, other legal systems do not have such requirements. However, in almost all systems, only those agencies that can show large market acceptance are recognised: in part, this is elevated to an express criterion, in other cases, it is applied as an indicator of the reliability and trustworthiness of the agency, in yet other cases, a listing of only noteworthy CRAs indirectly leads to this result. The competent authorities, in the same way as the SEC, do not appear to want to do away with this criterion as a guarantee of high professional standards and financial independence, despite the damaging effects on competition.

#### 3.1.1.3. Substantive regulation

##### 3.1.1.3.1 Scope of the substantive recognition criteria

In recognition procedures, there are, in part, substantive requirements as to the organisation and/or the activities of CRAs. Examples of these are the requirements for ECAIs based on Basel II, as well as the Italian rule that sets out minimum standards regarding the organisation, the qualification of analysts and the compliance with professional standards by the CONSOB. Furthermore, the definition proposal of the SEC should be mentioned here: according to it, in addition to market acceptance, a NRSRO is characterised by the fact that it “uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interests, and prevent the misuse of non-public information, and has sufficient financial resources to ensure compliance with those procedures.”<sup>80</sup>

Here, substantive standards are set that affect the structure and activities of CRAs. They do not constitute general preconditions to act, but rather, are merely useful for attaining state recognition. However, in light of the oligopoly, approximately 90% of all credit ratings are compiled by CRAs recognised in this way. If this is supplemented by an ongoing examination,<sup>81</sup> these standards could turn out to have a controlling effect on ongoing activity. However, even then, these simple minimum standards are too incomplete to be able to apply as genuine substantive rules.

##### 3.1.1.3.2. No special regulation for Credit Rating Agencies

Special rules for the activities of CRAs are not found anywhere. In particular, neither the rules provided by the EC for the activities of investment service companies<sup>82</sup> nor the special

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<sup>80</sup> See the proposal for a revised form of section 240.3b-10 of part 240 of the Exchange Act of 1934, displayed in SEC, *supra* note 16, at 73 *et seq.*; *cf.* in contrast *infra* note 92.

<sup>81</sup> Provided by CEBS, *supra* note 78, n. 59 *et seq.* for the conversion of the ECAI approval.

<sup>82</sup> As CRAs may neither consult nor act as an agent, *see supra* note 56.

rules for financial analysis set out in the market abuse guideline and the accompanying implementation guideline<sup>83</sup> apply to the activities of CRAs. Rather, there should be such internal rules of procedure as envisaged by the European legislature in order to disclose conflicts of interest and appropriately combat them. Notwithstanding that, in Italy, an implementation of the rules in excess of the original scope of application was considered, whereby CRAs were intended to be expressly included in the provisions foreseen for investment service companies.<sup>84</sup> However, concerns about such a domestic anomaly were not only raised from the perspective of EU law,<sup>85</sup> rather, according to the general view,<sup>86</sup> it would have also meant a competitive disadvantage for the Italian companies. Therefore, the implementation law adopted in December 2005 specifically does not apply to CRAs.

Consequently, there are no special rules on professional law found in any of the legal systems compared; there are neither binding requirements for the structure and organisation of the agencies, nor procedural requirements, evaluation standards and rules on transparency and publication.

#### 3.1.1.3.3. General rules

By way of contrast, the general rules on the protection of business secrets and confidential information, as they appear in the applicable public and contract laws, can be used. Furthermore, within the European Union, the insider law of the market abuse guideline<sup>87</sup> is applicable, which, indeed, does not present any particular problems in its legal application.<sup>88</sup> However, in North America, special rules on the disclosure of information in the internal relationship between CRA and issuer can be found because there, in contrast to the EC, the partial disclosure of information is still generally prohibited even if the recipient is subject to a duty of confidentiality. Although in Canada,<sup>89</sup> an exception to the prohibition against partial disclosure of information was made with respect to CRAs, in the USA,<sup>90</sup> the admissibility is still dependent on the subsequent publication of the rating report.

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<sup>83</sup> Art. 6 X Dash 6 of the Market Abuse Directive 2003/6/EC, ABl. 2003 L 96/16, in conjunction with the Conversion Directive 2003/125/EC, *supra* note 58.

<sup>84</sup> Sica (I), *supra* note 15, p. 7 *et seq.*

<sup>85</sup> Explicitly contradicting the preference for self-regulation in reason 10 of the Conversion Directive, *supra* note 58. *Cf.* for critical comments Sica (I), *supra* note 15, at 7 *et seq.*; affirming a contradiction to European Law also G. Deipenbrock, *Was ihr wollt oder der Widerspenstigen Zähmung? – Aktuelle Entwicklungen der Regulierung von Ratingagenturen im Wertpapierbereich*, 2005 Betriebs-Berater (BB) 2085, at 2088 *et seq.*

<sup>86</sup> Sica (I), *supra* note 15, p. 8 *et seq.*

<sup>87</sup> *See supra* note 83.

<sup>88</sup> CESR, Technical Advice to the European Commission on possible measures concerning credit rating agencies, March 2005, n. 119 *et seq.*

<sup>89</sup> Rousseau (CAN), *supra* note 26, II. B. 3., p. 31 *et seq.*

<sup>90</sup> Pinto (US), *supra* note 25, at 346 in n. 28, 29.

Moreover, the rating itself, or even, potentially, the mere commissioning of one, could give rise to a publication obligation on the issuer, since even a planned rating, or changes to an existing one, can have an influence on prices on the market.<sup>91</sup>

#### 3.1.1.4. Supervision

In most of the legal systems examined, there is, at this stage, no particular competence vested in a state authority for the ongoing activities of CRAs.<sup>92</sup> However, the situation is different in France: there, the general financial supervisory board *Autorité des marchés financiers* (AMF), an independent administration authority, is under an obligation to supervise (*surveillance*)<sup>93</sup> the activities of CRAs. This comprises, in particular, the compilation of an annual report on the role of the CRAs active in France. In addition, the AMF is supposed to, in cooperation with the agencies, promote the development of professional standards; however, the authority to intervene has not been granted. In the USA, parallel to its efforts on promulgating a definition of the NRSRO status, the SEC pursues an approach of “voluntary” oversight of whether the agencies are continuing to satisfy the recognition requirements.<sup>94</sup> On the one hand, this concept avoids state compulsion and, on the other, the envisaged ongoing control actually only refers to compliance with minimum standards (see above 3.1.1.3)).

Consequently, the approaches taken in the USA and France are really more appropriately classified as monitoring. With respect to state control/supervision, not only the authority to use compulsion, but also a detailed substantive standard that could be used to assess behaviour is lacking.

#### 3.1.1.5 Summary

A comprehensive state regulation of credit ratings has not yet taken place in any of the legal systems examined. Neither a licensing procedure as a requirement for entering the field, nor genuine state supervision, is in place. Substantive regulations on the control of behaviour are few and far between. Consequently, there are no noteworthy effects on the control of behaviour that could be derived from the existing control provisions.

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<sup>91</sup> CESR, *supra* note 88, n. 133 *et seq.*; Habersack, *supra* note 15, at 196, n. 56.

<sup>92</sup> The Swiss Federal Banking Commission stresses that the recognition process as ECAI is not a means of surveillance, *cf.* the explanatory notes concerning the draft circular of 26 July 2006, p. 18, available at: <http://www.ebk.admin.ch/e/regulier/regulierungsprojekte.html>.

<sup>93</sup> *Cf.* profile of *Autorité des marchés financiers*, available at: [http://www.amf-france.org/affiche\\_page.asp?urldoc=lesmissionsamf.htm&lang=fr&Id\\_Tab=0](http://www.amf-france.org/affiche_page.asp?urldoc=lesmissionsamf.htm&lang=fr&Id_Tab=0) (update of 04/08/2006).

<sup>94</sup> Rousseau (CAN), *supra* note 26, III. B. 2. a), p. 44.

### 3.1.2. Liability

In addition to rules under supervisory laws, the legal and commercial environment is decisively determined by civil-law liability risks. Since specific liability norms are lacking, recourse must be had to general claims under capital market and civil laws in all legal systems. With respect to the particularities in each state, reference is made here to the very informative national reports. However, even a systematic overview would be disproportionate and, due to the necessary curtailment, could give rise to the risk of producing a distorted picture and steamrolling differences. Consequently, attention will only be paid to a select few points here and an attempt will be made to uncover fundamental principles in order to determine the liability risks for CRAs in each legal system. The claims of the main recipients of ratings, namely the issuers and the foreign capital investors, will be addressed. Shareholder or other creditor interests, as well as possible claims from competitors, will not be addressed.

#### 3.1.2.1. Starting point for liability due to an erroneous rating

Difficulties are already encountered when seeking a basis for liability for an erroneous rating, as the tender of a rating grade does not constitute a pure statement of fact. Rather, a prognosis on the future ability and willingness of a debtor to pay will be set out. Even if, owing to their subtle classification and standardised semi-objectivity, the publication of grades gives rise to the impression that facts are being dealt with, an appraisal of future developments is given, in which, due to its very nature, a subjective element is present. Therefore, first and foremost, an expression of opinion is made, which cannot be categorised *ex ante* as “right” or “wrong”.<sup>95</sup> Furthermore, CRAs continually refer to this in their disclaimers in order to delimit the recipients’ expectations right from the very beginning.<sup>96</sup>

Therefore, it cannot be concluded that a rating was incorrect solely due to the fact that the rating grade turns out to be unfounded *ex post*.<sup>97</sup> Consequently, CRAs do not incur any liability for the mere fact that the prognosis does not turn out to be true. However, liability of the rating agency can indeed be considered when it, contrary to its obligations, bases its rating on unfounded or incomplete data sources or does not carry out the prognosis properly.

In turn, difficulties arise here: usually, damages will only be allowed if the error in the rating *process* is also reflected in the rating *result*. Any efforts by the external third party

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<sup>95</sup> However, in the case of a negative rating of short-term bonds, the evaluation of future financial solvency appears due to the close date of redemption regarding the current liquidity of the issuer, Peters, *supra* note 3, at 54.

<sup>96</sup> Cf. Wymeersch & Kruithof (BEL), *supra* note 15, at 405 *et seq.*

<sup>97</sup> J. Hennrichs, *Haftungsrechtliche Aspekte des Ratings*, in FS Hadding (2004), p. 875, at 881.

to obtain evidence are generally doomed to fail, due solely to the fact that the methods and algorithms used do not become transparent.<sup>98</sup> In this way, the allocation of the burden of proof gains decisive significance.<sup>99</sup>

Furthermore, there must be defined behavioural obligations imposed. Such obligations receive, at most, incomplete attention in the individual contracts and there is no comprehensive state regulation. In order to determine the core elements of professional obligations, which could then, through contractual interpretation or within the scope of tortious liability, gain indirect effect, one could consider referring to the criteria for recognition as NRSRO or ECAI.<sup>100</sup> However, even these remain mere minimum standards. In addition, uncertainties arise since there is no established case law.

### 3.1.2.2. Liability to the issuer

#### 3.1.2.2.1. Solicited rating

Damages claims of the issuer rated are especially conceivable in the case of a low evaluation, an unjustified downgrade or a refusal to upgrade, as, due to the unfairly poor rating grade, the issuer will only succeed in obtaining liquidity on the capital market under poor conditions. If the rating concerned is a solicited rating – as is often the case –, then an erroneous rating generally<sup>101</sup> constitutes a breach of the obligations under the contract pursuant to which such rating was given.

However, two considerable hurdles exist to the pursuit of contractual claims. The first arises from the usual allocation of the burden of proof regarding the elements of the claim. This generally affects the aggrieved party. However, it begs the question of how the issuer should prove that it was unfairly poorly evaluated and, as a consequence thereof, was confronted with unreasonably high financing costs.<sup>102</sup> Not only would it have to prove the procedural error, but also its influence on the final result. Therefore, in German academic discourse,<sup>103</sup> a partial reversal of the burden of proof, with reference to investment advice

<sup>98</sup> For all Vetter, *supra* note 12, at 1706.

<sup>99</sup> Cf. Habersack, *supra* note 15, at 201. Damages resulting directly from a breach of duty (e.g. exceeding the time-limit for publication) are unproblematic.

<sup>100</sup> See also Hennrichs, *supra* note 97, at 882; Habersack, *supra* note 15, at 201.

<sup>101</sup> In the US, the remuneration of the underlying contract seems to be the basic condition, Pinto (US), *supra* note 25, at 353, n. 70. Cf. also, Court of Civil Appeals of Oklahoma, Division No. 4, Commercial Financial Services Inc. v. Arthur Anderson v. Standard & Poor's, 94 P.3rd, 106 (2004). As already stated, normally the issuers pay.

<sup>102</sup> See De Savornin Lohman & Van 't Westeinde (NL), *supra* note 17, 'Liability of CRAs – Contractual Liability', p. 9; concerning the legal situation in Germany see G. Deipenbrock, *Externes Rating – "Heilversprechen für internationale Finanzmärkte"?*, 2003 BB, 1849, at 1852.

The liability for damages resulting directly from the breach of contractual duties relating to procedure and diligence is simple to justify. As such a breach of duty, the National Reports cite as examples: disclosure of company secrets, incomplete analysis of data or providing apparently wrong data, exceeding the time-limit for publication or unauthorised publication of an inherently accurate rating.

<sup>103</sup> D. Krimphove & O. Kruse, *Regulierung und Haftung von Ratingagenturen: Status quo und Perspektiven*, 2005 Zeitschrift für das gesamte Kreditwesen 413, at 415; left open by Hennrichs, *supra* note 97, at 882 *et seq.*; in contrast see Vetter, *supra* note 12, at 1706 *et seq.*

practices, is being considered as a way out of this problem; however, how the judiciary will decide in this regard is still uncertain. Having to prove fault would be even more difficult; however, in this area, legal rules on the reversal of the burden of proof can often be found.<sup>104</sup>

In any case, however, contractual liability is trumped by the standardised contractual clauses on limitations of and exclusions from liability. For example, in addition to many other limitations, Moody's uses the following formulation:<sup>105</sup>

No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such rating or other opinion or information is given or made by Moody's in any form or manner whatsoever.

An unrestricted limitation of contractual liability in advance does not appear to be permitted in any of the participating legal systems and, as a standard contractual term, is usually subject to the requirement of reasonability, which has occasionally needed to be clarified in each individual case.<sup>106</sup> Nevertheless, the following results can be used as general guidelines: as far as can be seen, an exclusion of liability for deliberate actions is not possible anywhere; however, the majority of the legal systems examined allow an exclusion of liability for slight negligence,<sup>107</sup> and in some cases, even for gross negligence<sup>108</sup> in business dealings. However, the concern is voiced in Germany that, due to the CRAs' position of trust, careful evaluation is such a fundamental contractual obligation that even an exclusion of liability for slight negligence endangers achieving the purpose of the contract and is thereby invalid.<sup>109</sup> Accordingly, the only thing that would be permissible would be a limitation of liability. In this context, it is important to note that, at least under German law, where an exclusion of liability clause is too extensive, it cannot be reduced to the legally permissible amount, but is, instead, entirely null and void.

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<sup>104</sup> An assumption of fault exists *e.g.* in Germany (§280 Abs. 1 p. 2 Bürgerliches Gesetzbuch (BGB)) and in Switzerland (*see* Trindade & Senn (CH), *supra* note 21, at 153); following Wymeersch & Kruithof (BEL), *supra* note 15, at 374, the situation in Belgium is differentiated: an assumption of fault exists only for procedural errors, not for forecast errors.

<sup>105</sup> The text is attached by default to each Credit Rating. *See* at: [www.moody.com](http://www.moody.com) (update of 04/08/2006).

<sup>106</sup> *E.g.* in the Netherlands, *cf.* De Savornin Lohman & Van 't Westeinde (NL), *supra* note 17, 'Liability of CRAs – Contractual Liability', p. 10.

<sup>107</sup> *E.g.* in Switzerland, *see* Trindade & Senn (CH), *supra* note 21, at 154 and in Greece, *cf.* Gortsos (GR), *supra* note 19, n. 53.

<sup>108</sup> Wymeersch & Kruithof (BEL), *supra* note 15, at 377 *et seq.*

<sup>109</sup> According to § 307 Abs. 2 Nr. 2 Bürgerliches Gesetzbuch (BGB); *cf.* W. Däubler, *Unternehmensrating – ein Rechtsproblem?*, 2003 BB 429, at 433; C. T. Ebenroth & T. Daum, *Die rechtlichen Aspekte des Ratings von Emittenten und Emissionen*, 1992 WM, Supplement n°5, p. 11; Hennrichs, *supra* note 97, at 884; and already Peters, *supra* note 3, p. 83 *et seq.*; in contrast the legal situation in Belgium, Wymeersch & Kruithof (BEL), *supra* note 15, at 378 *et seq.*

### 3.1.2.2.2. Unsolicited rating

Extracontractual liability to the issuer for an erroneous rating becomes especially relevant if no contractual relationship exists, namely, in the case of an unsolicited rating.<sup>110</sup> If an erroneous rating causes damage to the issuer, then a tortious claim for damages can be considered in all legal systems. Although, generally, there are no exclusion of liability clauses to rock the boat where there is no contractual relationship,<sup>111</sup> there is often the additional evidentiary problem of proving fault.<sup>112</sup>

#### 3.1.2.2.1.1. Observance of freedom of speech/freedom of the press

Moreover, it must be kept in mind that the compilation and publication of ratings is part of the constitutional protection of freedom of speech or freedom of the press in all legal systems involved,<sup>113</sup> with the exception of Canada.<sup>114</sup>

In the USA,<sup>115</sup> this leads to extensive limitations of liability. The tort of libel is generally subject to the respondent's right of free speech. Even if the basis for the prognosis is incorrect or the statements of fact linked with the expression of opinion are wrong, no strict liability for negligence can apply, as, otherwise, the constitutional right of freedom of speech would be impaired. Consequently, courts generally only sanction bad faith or reckless behaviour, such as a refusal to accept responsibility for the incorrectness of data.

There is a lack of case law in the remaining countries. However, it is clear that the protection of the freedom of speech of the rating agency does not apply unconditionally, but rather, the constitutional right to free speech, on the one hand, must be weighed against the interests of the issuer rated that need protection, on the other. In Germany, this contemplative process leads to the analogous application of the case law on product testing; accordingly, the agency is subject to the commands of neutrality, objectivity and expertise.<sup>116</sup> The facts upon

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<sup>110</sup> In Belgium and Greece, redress per tort is not possible in the case of a breach of contractual duties: Wymeersch & Kruithof (BEL), *supra* note 15, at 382 *et seq.*; Gortsos (GR), *supra* note 19, n. 54.

<sup>111</sup> *Cf.* the comments of Wymeersch & Kruithof (BEL), *supra* note 15, at 405 *et seq.* In the US, the mandate ought to be remunerated (*supra* note 101).

<sup>112</sup> De Savornin Lohman & Van 't Westeinde (NL), *supra* note 17, 'Non-contractual liability – Rating in a prospectus relating to a note issue', p. 15 state that under certain circumstances, a shift of the burden of proof is possible in the Netherlands.

<sup>113</sup> Pinto (US), *supra* note 25, at 352 – 1<sup>st</sup> Amendment; in Europe, already according to Art. 10 of European Convention on Human Rights, *cf.* Chaput (F), *supra* note 47, at 493; Wymeersch & Kruithof (BEL), *supra* note 15, at 384 *et seq.* – Art. 19 of the Constitution; *see* Trindade & Senn (CH), *supra* note 21, at 145 – Art. 16 of the Constitution; De Savornin Lohman & Van 't Westeinde (NL), *supra* note 17, 'Non-contractual liability – Unsolicited rating', p. 18 – Art. 7 of the Constitution; Gortsos (GR), *supra* note 19, n. 12 – Art. 14, para. 1 of the Constitution; in Germany Art. 5 Grundgesetz; also stating the protection of human rights, Lemonnier (POL), *supra* note 20, I. 2.2, p. 4.

<sup>114</sup> Rousseau (CAN), *supra* note 26, II. B. 4., p. 33, only names the American 1<sup>st</sup> Amendment.

<sup>115</sup> Pinto (US), *supra* note 25, at 352 *et seq.*

<sup>116</sup> For all Peters, *supra* note 3, p. 73 *et seq.*

which the evaluation is based must be carefully determined and the result must be justifiable due to a substantiated rating procedure. In the Netherlands,<sup>117</sup> in order to determine the duty of care, the circumstances of the individual case, such as the extent of the promulgation and the appearance of neutrality and expertise that the party making the rating inspires in the public eye, are to be taken into account in a comprehensive deliberation process. The Belgian reporters,<sup>118</sup> in particular, expect comparatively high standards of care.

#### 3.1.2.2.1.2. Liability for error-free rating

Furthermore, liability for an, in itself, error-free rating could also be conceivable. Damage to the issuer could arise in the case of an undesired detrimental rating by calling its creditworthiness into public dispute and, thereby, causing an increase in financing costs and endangering customer relationships. However, in all the legal systems involved, the unsolicited rating is not generally forbidden. Therefore, for reasons of consistency, claims for damages or injunctions in case of an error-free rating are not allowed in any of the legal systems. An American court confirmed that this applies even where the rating agency wanted to deliberately punish the issuer for commissioning a competitor.<sup>119</sup>

By way of contrast, the legal situation in Germany has not been entirely clear since the Federal Supreme Court's<sup>120</sup> decision that an academic's specific and repeated reference in seminars to annual reports that were publicly accessible anyway was a breach of the privacy rights of the business concerned, as, thereby, deliberately critical opinions were apparently provoked and that the academic should also have, for his purposes, made use of an anonymous form of the financial statements. Regardless of the general concerns regarding the correctness of this decision,<sup>121</sup> it cannot be extended to include rating reports, as, on the one hand, the data itself is not made public, but only a resulting study<sup>122</sup> and, on the other, in contrast to the case decided, ratings require and justify specifically naming the issuer, as only then can the agencies satisfy their constitutionally protected role of information intermediary.

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<sup>117</sup> De Savornin Lohman & Van 't Westeinde (NL), *supra* note 17, 'Non-contractual liability – Unsolicited rating', p. 18.

<sup>118</sup> Wymeersch & Kruithof (BEL), *supra* note 15, at 401 *et seq.*

<sup>119</sup> Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc., Further references and comments: Pinto (US), *supra* note 25, at 354 *et seq.*

<sup>120</sup> Bundesgerichtshof (BGH) of 02/08/1994, Az. VI ZR 286/93, *Neue Juristische Wochenschrift* (NJW) 1994, 1281.

<sup>121</sup> Further references by C. T. Ebenroth & S. Koos, *Juristische Aspekte des Ratings*, in H. E. Büschgen & O. Everling, *supra* note 5, p. 483, at 490.

<sup>122</sup> Deipenbrock, *supra* note 102, at 1851 *et seq.*

### 3.1.2.3. Liability to investors

The situation is more difficult to judge if the damages are not incurred by the issuer, but instead by the investors. In all legal systems compared, rating agencies would incur civil liability if third parties were consciously intended to suffer damage through the issuance of an incorrect rating grade. However, this will very rarely be the case. Rather, the question of the agencies' liability for a negligently too positive evaluation of the issuer or its product, for a delay in issuing a downgrade, or for negligently caused procedural and publication errors, attains significance.

#### 3.1.2.3.1. Expert liability or commercial press

Even if the large CRAs emphasise that they do not assume any responsibility for the correctness of their prognoses, do not make any recommendations and, in particular, do not hold any expert status, they still describe their product as one that was compiled objectively, neutrally and on an academic basis. CRAs present themselves as bodies with particular expert knowledge, which, owing to their quality and neutrality, enjoy great confidence with the investor public. The CRAs are also reliant on this image if they are to satisfy their role as an information intermediary. Therefore, in the national reports, the responsibility of CRAs to the investor public is usually discussed in the context of analogous issues regarding accountants or expert advisors.

Although the significance of a rating appraisal is, to a large extent, comparable with that of an attestation by an accountant, a grave difference still lies in the fact that the CRA does not have access to files to the same extent, i.e., it does not have the same degree of access to the business sphere.<sup>123</sup> Furthermore, the circle of recipients of information and, thereby, the potential creditors, is much larger with respect to a rating than it is with an expert advisor. Owing to the publication aspect of a rating, there is the additional risk that a stricter standard of liability could result in a considerable number of abusive claims and investors would be tempted to shift their general investment risks onto the rating agencies. Therefore, the publication of rating reports, despite their commercial character, demonstrates more similarities with general publications of the business press than with attestations of an accountant, who is under an obligation to provide information. Furthermore, the risks associated with affirming a general liability for rating agencies could lead to "defensive ratings", or also to a reduced exchange of information.<sup>124</sup>

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<sup>123</sup> H. Fleischer, Gutachten F für den Deutschen Juristentag 2002, F 141; detailed G. Husisian, *What Standard of Care Should Govern the World's shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 *Cornell L. Rev.* 411, at 460 (1990).

<sup>124</sup> These dangers have been considered explicitly in the US, cf. Pinto (US), *supra* note 25, at 351 *et seq.*; concerning the jurisdiction see Husisian, *supra* note 123, at 434, 460.

The proximity to the publications of the business press thereby leads once again – as far as the consequences of liability are concerned – to a discussion on the extent of the freedom of the press. This is distinctive in the USA, where – not only based upon the 1st Amendment – the standard of liability has been relaxed to mere ‘reckless liability’. It remains to be seen how practices will evolve in the remaining legal systems. The Greek report<sup>125</sup> expects that the courts will not recognise any liability to the general public. In the Netherlands, the national reporters expect a milder standard of liability for issuer ratings than for accountants.<sup>126</sup> By way of contrast, the Swiss reporters<sup>127</sup> predict a strict standard of care; in Belgium,<sup>128</sup> also, the courts are known to be traditionally claimant-friendly and demand high standards of the business press in upholding professional obligations.

Whilst in most countries, a tortious catch-all provision sanctions unlawful and culpable damage to third parties, and under common law, a suitable claim basis is available in the form of the tort of negligent misrepresentation, Germany lacks a basis for extra-contractual liability in negligence for damage to assets.<sup>129</sup> Instead, there, the discussion revolves around a contractual breach, which is basically concerned with establishing whether the contract between the issuer and the rating agency offers protection for the benefit of the general investor public, or whether the rating agency, as a non-party to the contract between issuer and investor, can, by way of exception, be held contractually liable due to its special position of trust.<sup>130</sup> To some extent, the view is held that, solely, the subscription to the rating journal of the agency in question can result in liability for erroneous rating. Thereby, the circle of parties entitled to bring a claim would be limited to the subscribers.<sup>131</sup>

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<sup>125</sup> Gortsos (GR), *supra* note 19, n. 43.

<sup>126</sup> De Savornin Lohman & Van ‘t Westeinde (NL), *supra* note 17, ‘Non-contractual liability – Solicited Rating’, p. 17, refer to a decision of the House of Lords concerning the liability of accountants, without explaining how the required sufficient proximity between plaintiff and accountant influences the liability of the CRA to the general public. Concerning the attended stricter liability regarding the emission rating, *see infra* note 137.

<sup>127</sup> Trindade & Senn (CH), *supra* note 21, at 155 *et seq.*

<sup>128</sup> Wymeersch & Kruithof (BEL), *supra* note 15, at 401 *et seq.*

<sup>129</sup> *See* however the tendencies towards a diminished requirement of intent in § 826 Bürgerliches Gesetzbuch (BGB) H. Fleischer, *Konturen der kapitalmarktrechtlichen Informationsdeliktshaftung. Zugleich Anmerkung zu BGH, U. v. 09.05.2005 – II ZR 287/02 – (EM.TV)*, in ZIP 2005, 1805 at 1806; G. Spindler, in H. G. Bamberger & H. Roth, § 826 Note 35.

<sup>130</sup> Affirming *e.g.* Witte & Hrubesch, *supra* note 6, at 1351; *see also* Diskussionsbericht zum Vortrag von M. Habersack at C. Kersting, *Diskussionsbericht zu den Referaten von Hinrichs, Habersack und Wittig*, 169 ZHR 242, at 246 (2005). The protection of third parties is also discussed in Poland, Switzerland and the US referring to agencies’ unwillingness to accept contractual liability towards third parties: Trindade & Senn (CH), *supra* note 21, at 155; Lemonnier (POL), *supra* note 20, III. 1.3, p. 15; Pinto (US), *supra* note 25, at 353 in n. 70; *also* Gortsos (GR), *supra* note 19, n. 56.

<sup>131</sup> Habersack, *supra* note 15, at 205 *et seq.*; Hennrichs, *supra* note 97, at 885 *et seq.* against the former prevailing opinion; regarding the issue in Switzerland, *cf.* Trindade & Senn (CH), *supra* note 21, at 155; raising economic arguments, Husisian, *supra* note 123, at 435.

### 3.1.2.3.2. Proof of damage caused by the erroneous rating

In addition to the already encountered evidentiary difficulties regarding breach of obligations and fault, showing actual damage and proving the causal link establishing liability are also problematic. If one considers damage to have occurred solely from the failure of the bond, then the aggrieved party would have to prove that it had only undertaken the investment due to the too optimistic grading by the CRA. As experience with erroneous *ad-hoc* communications has shown, this evidence is extremely difficult to furnish.<sup>132</sup>

In many legal systems, a reversal of the burden of proof is recognised in the case of investments on the primary market after publication of an incorrect prospectus: it is often assumed that the general mood of the market is positively influenced by the publication of an erroneous sales prospectus. In Switzerland,<sup>133</sup> it is possible for a CRA to be held responsible if it decisively influenced the compilation of the bond flotation prospectus of a public share company. In contrast, the special rules of securities law in Canada<sup>134</sup> and the USA<sup>135</sup> have as little relevance in this area as the principles on prospectus liability under stock exchange and civil laws do in Germany.<sup>136</sup> A special feature is contained in the Netherlands national report:<sup>137</sup> Dutch law recognises a shift in the burden of proof, which occurs regardless of whether the CRA itself publishes the rating on the occasion of a new issue, or merely permits the issuer to allow access to the rating.

The investor could be helped in other ways regarding investment decisions on the secondary market. According to the ‘efficient capital market hypothesis’,<sup>138</sup> capital markets process information so well that the price of the individual financial instruments always reflects all fundamental information gained at that point. Therefore, American courts, in their case law concerning ‘fraud on the market theory’, have generally not, in the last 30 years, required any proof that the claimant was *actually* influenced where incorrect capital market information was published on the secondary market.<sup>139</sup>

I am not aware of an application of the ‘fraud on the market theory’ to the publication of erroneous rating reports as well. However, studies exist which show the existence of a relationship between the tender of or changes to rating grades, and the costs of capital

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<sup>132</sup> Hennrichs, *supra* note. 97, at 891, referring to parallel procedures in the case of incorrect *ad hoc* announcements; *see also* Gortsos (GR), *supra* note 19, n. 43.

<sup>133</sup> Trindade & Senn (CH), *supra* note 21, at 156 *et seq.*; *cf. also* further references in Fleischer *supra* note 123, F 140.

<sup>134</sup> Rousseau (CAN), *supra* note 26, II. B. 4. (p. 32).

<sup>135</sup> Fleischer, *supra* note 123, F 140.

<sup>136</sup> Fleischer, *supra* note 123, F 140; Ebenroth & Daum, *supra* note 109, Supplement N°5, 15 *et seq.*

<sup>137</sup> De Savornin Lohman & Van ‘t Westeinde (NL), *supra* note 17, ‘Non-contractual liability – Rating in a prospectus relating to a note issue’, p. 12 *et seq.*

<sup>138</sup> T. Baums, *Haftung wegen Falschinformation des Sekundärmarktes*, 167 ZHR 139, at 180 *et seq.* (2003).

<sup>139</sup> Blackie v. Barrack, 524 F. 2d 891 (9<sup>th</sup> Cir. 1975); Basic v. Levinson, 485 US 224 (1988).

market products. Thereby, damage incurred by investors could generally be founded on the erroneous rating report, even in the absence of current influence and reliance, by showing that the title in question was acquired at an inflated price owing to the rating. The damage would then comprise the difference between the price paid and the price that, *ex ante*, would have accurately reflected the risk.<sup>140</sup> However, according to a study of the French AMF,<sup>141</sup> the association is not as close as expected and, moreover, does not appear to be quantifiable with certainty. Therefore, in contrast to the Belgian national reporters,<sup>142</sup> I believe that a general acceptance of such causality in the case of erroneous ratings is still premature. Rather, for the time being, we should wait for further developments in economic research.

#### 3.1.2.4. Summary

Liability claims against CRAs owing to erroneous ratings in breach of their duties are currently burdened with considerable problems of execution and have limited prospects of success. On the one hand, this is due to considerable evidentiary problems, on the other, however, due to often reduced standards of care: in the contractual area, these result from contractually-agreed limitations of liability; outside contractual relationships, they serve to not only protect freedom of speech and of the press, but also to limit the risks of liability to a reasonable amount. The assessment of the prospects of success of claims arising from erroneous ratings varies between the different nations: whilst both the French and the Canadian reports obviously hold liability claims to be hopeless and talk about a purely academic question,<sup>143</sup> the Belgian reporters<sup>144</sup> regard liability for negligently incorrect evaluation to, indeed, be realistic. In some legal systems, divergences from the standards of care, at least in the case of solicited ratings, ought to signify for the agencies a not inconsiderable risk of liability to the issuer.<sup>145</sup>

#### 3.1.3. The Special Case of Latin America

A special case of legal regulation can be seen in some countries of Latin America: in Chile, El Salvador and Peru, comprehensive regulation of the activities of CRAs exists. Unfortunately, national reports from this region are not available. Nonetheless, a short look at the paradigmatic situation in Chile is certainly of interest:

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<sup>140</sup> Wymeersch & Kruithof (BEL), *supra* note 15, at 404 refer to this possibility.

<sup>141</sup> AMF, *supra* note 31, p. 53.

<sup>142</sup> Wymeersch & Kruithof (BEL) *supra* note 15, at 404.

<sup>143</sup> Chaput (F), *supra* note 47, at 500; Rousseau (CAN), *supra* note 26, II. B. 4., p. 32.

<sup>144</sup> See the evaluation in Wymeersch & Kruithof (BEL), *supra* note 15, at 418.

<sup>145</sup> J. Fiala, C. Kohrs & S. Leuschner, *Die Haftung des „Experten“ für anlagebeeinflussende Äußerungen am Beispiel der Haftung für Versicherungsratings*, 2005 *Zeitschrift für Versicherungsrecht (VersR)* 742, at 749: 'heavy' risks; contrasting Habersack, *supra* note 15, at 203.

In 1987, a chapter on *Clasificadoras de Riesgo*<sup>146</sup> was included in the Chilean Securities Market Law.<sup>147</sup> CRAs are subject to state registration and supervision by the *Superintendencia de Valores y Seguros* (SVS), which can also impose sanctions and revoke licences. The agencies must show a certain organisational form and a minimum capitalisation. Prohibitions on activity are imposed to avoid conflicts of interest and general procedural and evaluation norms are regulated. Issuers of publicly offered bonds are under a duty to obtain ratings from two independent agencies at their own cost. The SVS is also allowed to assign agencies to issuers and even to order that CRAs be admitted to business offices for the purpose of gaining access to files. Furthermore, the law provides for a general liability for all damages incurred by third parties arising from deliberate or negligent actions (*actuaciones dolosas o culpables*). This is incurred as joint and several liability by both the participating agencies and the individual persons involved.

### 3.2. Developments for Future Regulation

For a considerable time, the activities of rating agencies have been the subject of commercial academic discourse. In contrast, the interest of the legal field was, up until a few years ago, rather limited. However, following the headline-making collapses, this has changed and now various regulation plans are in the pipeline.

#### 3.2.1. IOSCO Principles and Code of Conduct Fundamentals

The most prominent study on this issue was undertaken by the International Organization of Securities Commissions, IOSCO. After a comprehensive consultation procedure, this led to the publication of the IOSCO Principles<sup>148</sup> Regarding the Activities of Credit Rating Agencies in September 2003. In these principles, very general objectives were set out for the activities of CRAs. Building on this, in December 2004, the IOSCO presented the Code of Conduct Fundamentals (hereinafter “IOSCO Code”), a template for a comprehensive code of behaviour.<sup>149</sup> Whilst the type and method of implementation and execution in the individual states was expressly left open in the Principles, it would appear that the IOSCO has now decided upon an approach of voluntary self-obligation.<sup>150</sup> The IOSCO Code does not assume legally-binding effect; however, the organisation entertains the expectation that the agencies

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<sup>146</sup> Title XIV, Art. 71-95, *cf. also* Peters, *supra* note 3, p. 147 *et seq.*

<sup>147</sup> Ley de Mercado de Valores, Ley No 18.045, available at: [www.svs.cl](http://www.svs.cl) (update of 04/08/2006).

<sup>148</sup> IOSCO, Statement of Principles regarding the Activities of Credit Rating Agencies, September 2003; published in parallel: IOSCO, Report on the Activities of Credit Rating Agencies, September 2003.

<sup>149</sup> IOSCO, Code of Conduct Fundamentals for Credit Rating Agencies, December 2004.

<sup>150</sup> However, in the Introduction to the Code, IOSCO agrees that additional measures and a regulatory implementation might become necessary in specific jurisdictions.

will give themselves their own appropriate behavioural guidelines. They are asked to identify deviations and to explain them.<sup>151</sup> The IOSCO Code, like the Principles before it, is dedicated to the following main causes:

- the Quality and Integrity of the Rating Process;
- CRA Independence and the Avoidance of Conflicts of Interest; and
- CRA Responsibilities to the Investing Public and Issuers.

### 3.2.2. Initiatives in the Individual Legal Systems

Parallel to this, the groundwork has been laid for the development of regulations, notably in the USA and at an EC-wide level.

#### 3.2.2.1. United States of America

As a consequence of the Enron collapse, the American SEC was entrusted with the task of investigating the role of CRAs by the Sarbanes Oxley Act.<sup>152</sup> In its further course of action, the SEC continued to pursue the NRSRO concept.<sup>153</sup> However, plans to be able to continually control compliance with the minimum standards set out in the NRSRO concept through agreement with the NRSROs themselves failed.

The Commission advocated comprehensive legal regulation; however, it did not regard itself as competent to undertake such a regulation. Congress has now been presented with a statutory bill from the member Fitzpatrick.<sup>154</sup> The adoption of this *Credit Rating Agency Duopoly Relief Act* would signify considerable changes: the requirements for NRSRO status would be substantively refined and the criterion of market acceptance, which has been recognised as prohibitive, would be done away with to promote increased competition; at the same time, the voluntary recognition would be transformed into a compulsory registration procedure. The SEC would receive a supervisory mandate, would be granted the authority to intervene to the point of being able to revoke the approval, and would be empowered to take a comprehensive, active role in the regulation process. This statutory bill was met with benevolent acceptance, but also considerable criticism from the side of the CRAs affected.<sup>155</sup>

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<sup>151</sup> IOSCO, *supra* note 149, Fundamental 4.1.

<sup>152</sup> SEC, Report on the Role and Function of Credit Rating Agencies, January 2003.

<sup>153</sup> *Supra* note 64.

<sup>154</sup> H.R. 2990, 109<sup>th</sup> Cong. (2005), available at: <http://thomas.loc.gov/cgi-bin/query/z?c109:H.R.2990>: (update of 04/08/2006).

<sup>155</sup> Cf. press release of 06/29/2005: *S & P States that Legislation to Regulate Credit Rating Agencies Overlooks Impacts on Markets, Threatens Quality and Diversity of Opinion, and is Unconstitutional*; available at: [www.standardandpoors.com](http://www.standardandpoors.com) (update of 04/08/2006).

In particular, concerns have been expressed about its compliance with the Constitution in light of the right to freedom of the press enshrined in the 1st Amendment.<sup>156</sup> The fate of the reform remains to be seen.

### 3.2.2.2. European Community

In the European Community, the Committee of European Securities Regulators (CESR) has been assigned the task of drafting a Technical Advice on possible regulation measures. This was presented in March 2005<sup>157</sup> and follows a “wait and see” approach: it is relying on the success of the IOSCO Code, not least due to the experiences with the NRSRO status, which constitutes a barrier to access. However, implementation and effectiveness should be monitored. For this purpose, voluntary compliance agreements were concluded with the large agencies of S & P, Moody’s, Fitch and Dominion Bond Rating Services.<sup>158</sup> Legislative measures ranging from voluntary registration to complete state supervision, such as in the banking industry, are only planned if the self-binding approach fails. In the meantime, the Commission has acceded to this “wait and see” approach.<sup>159</sup>

### 3.2.2.3. Other States

In other individual states, no further legislative initiatives are known. The Dutch Ministry of Finance expressly stated that it saw no need for state action.<sup>160</sup> However, the situation in France can be contrasted due to the supervisory task of the French AMF.<sup>161</sup> It may have no authority under supervisory laws to regulate or intervene; however, the report to be annually compiled deals with, among other things, the behavioural codes of the *agences de notation* and their compliance with the IOSCO guidelines, the transparency of the evaluation criteria used and the effect of their activities on issuers and investors. In addition, in cooperation with the CRAs, the *Autorité* works towards the development of professional standards.

Australia’s reaction to the IOSCO Code is interesting. In contrast to the opinion held in Europe, according to the Australian view, rating opinions are connected with the tendering of recommendations. Therefore, they generally fall under the licensing requirements for financial

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<sup>156</sup> Concerning constitutionality see F. Bottini, *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*, 30 San Diego L. Rev. 579, at 616-619 (1993).

<sup>157</sup> CESR, *supra* note 88, see Consultation Paper, *supra* note 39.

<sup>158</sup> Press release by CESR on 12/13/2005 and 03/09/2006, available at: [www.cesr-eu.org](http://www.cesr-eu.org) (update of 04/08/2006).

<sup>159</sup> Press release by DG Single Market on 01/09/2006.

<sup>160</sup> De Savornin Lohman & Van ‘t Westeinde (NL), *supra* note 17, ‘Regulatory Aspects – Subsequent Developments in NL’, p. 4.

<sup>161</sup> Cf. Chaput (F), *supra* note 47, at 500 *et seq.* and AMF, *supra* note 31, p. 4, as well as AMF profile *supra* note 93.

service providers.<sup>162</sup> Subsequent to the publication of the IOSCO Code, the Australian Securities & Investment Commission (ASIC) resolved to lift the approval requirements for CRAs as long as they published their own code of behaviour with a declaration of compliance and, on request, provided ASIC with information.<sup>163</sup>

### 3.3. Comment

In the last section of the general report, the current regulation attempts at an international level shall be reviewed.

#### 3.3.1. General Need for Regulation

##### 3.3.1.1. No market self-regulation

Firstly, the question of whether regulations are necessary at all is to be addressed. The agencies continue to refer to the fact that investors and issuers only accept reliable and serious business conduct in the long run, with the consequence that the market thereby regulates itself.<sup>164</sup> In fact, it is true that the quality of rating appraisals is generally high and that, in addition, investors have a very precise overview of the reliability of each agency.<sup>165</sup> However, the functional efficiency of the system must also be able to hold up in a crisis, and here, the experience of most recent financial scandals tells us that, in this regard, deficits exist.

The pressure of a reputation can, at best, establish a strong market opponent. However, even large investors are not in a position to exercise any noteworthy pressure,<sup>166</sup> and the issuers dependent on ratings, owing to the oligopoly, also regard themselves as being in a weak position.<sup>167</sup> Furthermore, a widespread realisation is that the large CRAs do not so much generate news as react to it,<sup>168</sup> and the view is even expressed that, with a rating, it is not information that is purchased, but instead, access to a legislative preference of the issuer.<sup>169</sup> From this, and from the most recent financial scandals, one could indeed conclude that the market has failed. In any case, the fact is that CRAs are required to balance a variety of conflicts of interest between issuers and investors and, at the same time, the market powers

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<sup>162</sup> Australian Corporations Act 2001, *cf.* press release by ASIC on 06/09/2005 *supra* note 58.

<sup>163</sup> Press release on 12/19/2005 *supra* note 58.

<sup>164</sup> Husisian, *supra* note 123, at 426; M. Schmidt, *Zweck, Ziel und Ablauf des Ratings aus Emittentensicht*, in H. E. Büschgen & O. Everling, *supra* note 5, p. 253, at 269; Fleischer, *supra* note 123, F 134 with further references.

<sup>165</sup> Husisian, *supra* note 123, at 441; contesting Bottini, *supra* note 156, at 583-595.

<sup>166</sup> Peters, *supra* note 3, p. 155 *et seq.*

<sup>167</sup> CESR, *supra* note 88, n. 260.

<sup>168</sup> *Cf.* F. Partnoy, Financial Times on 06/29/2005, p. 13.

<sup>169</sup> F. Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Washington University Law Quarterly 619, at 683 (1999).

can only have a limited effect due to the oligopoly structure. Self-regulation does not take place effectively where the pressure of reputation as a controlling power only exists to a certain, limited degree due to a lack of existing competition.<sup>170</sup>

### 3.3.1.2. No regulation through civil liability

Features that could potentially constitute a means of controlling behaviour are also present in private law, notably in the civil liability regime.<sup>171</sup> However, it has turned out that, in all the legal systems compared, liability claims can only be brought with difficulty. In particular, the CRAs appear to be immune to sanctions regarding their behaviour towards the general investor public. The lack of case law outside the USA clearly indicates that liability issues do not play a role. However, the only conclusion that this leads to is that the law of damages cannot ensure a fair distribution of the burden in cases of misconduct.<sup>172</sup> A preventive effect for the purpose of controlling CRA behaviour could, indeed, evolve from those liability claims that are merely difficult to bring,<sup>173</sup> as well as from those that only establish liability in cases of reckless or conscious deviation from the catalogue of obligations, as, even in these cases, the obligor will endeavour to follow its obligations. The problem lies somewhere else: such a concept relies upon the availability of a well-established and fixed set of obligations that is provided, so to speak, from “external sources”. This is precisely what is lacking where no legal regulation exists.

### 3.3.2. Substantive Content of Legal Regulation

From a substantive point of view, the IOSCO Code has been met with approval from all sides, even from the CRAs themselves,<sup>174</sup> and may serve as a basis for all further regulatory action. Therefore, it shall also form the basis of the following considerations.

#### 3.3.2.1. Independence of agencies and conflicts of interest

Particularly in need of legal regulation are the various conflicts of interest to which rating agencies are subjected. A first area of conflict arises from the fact that the issuers pay for the

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<sup>170</sup> Deipenbrock, *supra* note 23, at 263; Fleischer, *supra* note 123, F 135; Rousseau (CAN), *supra* note 26, II. B. 1., p. 29; otherwise in Switzerland: *see* Trindade & Senn (CH), *supra* note 21, at 145; *see also* Emmenegger, *supra* note 26, at 35.

<sup>171</sup> In detail G. Wagner, *Prävention und Verhaltenssteuerung durch Privatrecht – Anmaßung oder legitime Aufgabe*, 206 *Archiv für die civilistische Praxis (AcP)* 352-476 (2006).

<sup>172</sup> Peters, *supra* note 3, p. 154.

<sup>173</sup> Also Habersack, *supra* note 15, at 203.

<sup>174</sup> *Börsen-Zeitung* on 12/07/2004, p. 5.

solicited rating; these fees constitute the main source of income for an agency.<sup>175</sup> The danger of “courtesy” ratings cannot be fully excluded here, even if this risk is regarded as negligible by the CRAs.<sup>176</sup>

A further area of conflict is created by the auxiliary services that are increasingly offered by the agencies. The mere use of such services gives rise to the risk of the non-objectivity of a rating: on the one hand, it could easily be assumed that the rating grade is made dependent upon the use of the fee-incurring auxiliary services. Conversely, it would appear to be of questionable value if one and the same company first acts in an advisory, and then in an evaluating capacity – especially if the advice extends to a rating-oriented optimisation of the financial management<sup>177</sup> of a business. Finally, conflicts of interest can arise from a personal perspective, such as if individual decision-makers have a personal interest in a good or poor outcome of the rating, for example, because they themselves hold an interest in the business that is to be evaluated.

Such conflicts of interest can never be entirely excluded. However, in order to minimise the risks that arise from such conflicts, the greatest possible transparency is required. To this end, the IOSCO Code requires the organisational and personal separation of advisory services and rating activities through so-called ‘Chinese walls’<sup>178</sup> and, furthermore, contains a detailed catalogue of incompatibilities and disclosure obligations concerning equitable or emotional involvement<sup>179</sup> in order to ensure the functional independence of the agency and those involved in the rating process. In addition, like the American bill,<sup>180</sup> it focuses on the determination and publication of internal procedures to identify and avoid conflicts of interest and on the disclosure of any remaining opposing interests.<sup>181</sup>

The Code does not see any particular problem in paying for solicited ratings. It solely states that the respective analysts, themselves, are not allowed to have taken part in the previous negotiations concerning fees and that the general fee conditions are to be made public.<sup>182</sup> It would also be worth considering providing for a maximum quota that a single rating customer may have in the turnover of an agency,<sup>183</sup> in this way, the agency’s independence with respect

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<sup>175</sup> Following AMF *supra* note 31, it is more than 80%; Pinto (US), *supra* note 25, at 345 in n. 23 estimates the incoming of issuers at 95% (apparently including additional services).

<sup>176</sup> For further references see Pinto (US), *supra* note 25, at 344 *et seq.*

<sup>177</sup> S. Emmenegger, *supra* note 26, at 35.

<sup>178</sup> IOSCO, *supra* note 149, Fundamental 2.5.

<sup>179</sup> IOSCO, *supra* note 149, Fundamentals 2.11-2.16.

<sup>180</sup> Sec. 15E(h) of the Securities Exchange Act 1934 as amended by the *Credit Rating Agency Duopoly Relief Act*, *supra* note 154.

<sup>181</sup> IOSCO, *supra* note 149, Fundamentals 2.6-2.7.

<sup>182</sup> IOSCO, *supra* note 149, Fundamentals 2.12 and 2.8. See e.g. Standard & Poor’s Ratings Services US Ratings Fees Disclosure of 04/20/2005, available at: [www.standardandpoors.com](http://www.standardandpoors.com) (update of 04/08/2006).

<sup>183</sup> Fleischer, *supra* note 123, F 136; Habersack, *supra* note 15, at 196.

to the party commissioning the rating could be further ensured. On the other hand, one would have to consider the possibility of special conditions for small and new CRAs, as otherwise, renewed market entry hurdles could arise from such a regulation.

### 3.3.2.2. Requirements of the procedure

Another main concern of the IOSCO Code is the assurance of quality and integrity in the rating process, so that the CRAs can fulfil their task of dissolving information asymmetry on the market. In this context, one must keep in mind that the prognosis decision cannot be gauged as “right” or “wrong”. Therefore, a methodical and transparent procedure of compiling the rating product has an important role in quality assurance.

Firstly, each prognosis can only be as good as the data upon which it is based. However, such data usually comes from the party commissioning the rating, namely the business that is to be rated itself. Verification by the agencies does not currently take place. In particular, if the business concerned deliberately provides erroneous data and the results used bear an accountant’s attestation, it is also doubtful whether the rating agencies could, through their own examination, guarantee a higher degree of reliability at all. In any case the Code requires that all relevant data be completely analysed.<sup>184</sup> Upon publication, the agency must disclose whether it received internal data from the issuer or not.<sup>185</sup>

Rightly so, neither IOSCO nor CESR or SEC have suggested standardising the evaluation factors to be taken into account and the weight to be given to them. Standardisation would impinge on competition, which plays a decisive role as an innovation driving force.<sup>186</sup> Having said that, the market cannot be denied the justified expectation of learning of the basis on which an appraisal was given. A rating is not allowed to be a black box. Rather, the IOSCO Code enjoins the agencies to always publish sufficient information about the currently applicable significant methods and evaluation criteria, so that the reader can understand how the result was reached.<sup>187</sup>

According to the IOSCO Code, ratings decisions are to be published in a timely manner, free of charge and on a non-selective basis.<sup>188</sup> However, in order to achieve a ‘fair presentation’, the party commissioning the rating must, before publication – even when this leads to delays –, be given the opportunity to clear up any misunderstandings and to provide any relevant facts.<sup>189</sup> On the other hand, the non-publication of a rating that was not initially

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<sup>184</sup> IOSCO, *supra* note 149, Fundamentals 1.1 and 1.4.

<sup>185</sup> IOSCO, *supra* note 149, Fundamental 3.9.

<sup>186</sup> Also IOSCO, Report, *supra* note 149, p. 4 and CESR, *supra* note 88, n. 110 argue for the preservation of innovation possibilities; *see also* Habersack, *supra* note 15, at 194; Witte & Hrubesch, *supra* note 6, at 1353.

<sup>187</sup> IOSCO, *supra* note 149, Fundamentals 3.5 and 3.10.

<sup>188</sup> *Id.*, Fundamentals 3.1 and 3.4.

<sup>189</sup> *Id.* Fundamental 3.7.

intended to be “private” cannot depend on an arbitrary decision of one of the contractual parties.<sup>190</sup> Furthermore, after publication, an eye must be kept on further developments and, if need be, the rating should be updated.<sup>191</sup> The end of the ongoing supervision is to be announced.<sup>192</sup>

The assurance of the quality of a rating ultimately requires that the agencies satisfy high professional standards in the training and further education of their personnel.<sup>193</sup> In the compilation of a rating, the principles of objectivity, neutrality and expertise are to be observed by all participants at every stage of the process.<sup>194</sup>

### 3.3.2.3. Company secrets and insider information

The IOSCO Code contains regulations on dealing with confidential information. A solicited rating is generally associated with the transmission of internal company information to the rating agency. It is therefore necessary that the insider information obtained by the rating agency in this way is kept confidential.<sup>195</sup> Since the rating itself can potentially give rise to a publication obligation on behalf of the issuer,<sup>196</sup> the requirement of the timely publication of the rating serves, last but not least, to counteract the danger of the selective dissemination and “leakage” of the information in question.<sup>197</sup> Moreover, the confidentiality obligation also serves to uphold company secrets to the benefit of the issuer. Although basic protective provisions can be found in general civil and criminal law in this regard, a specific regulation of such obligations will increase the willingness of the issuer to disclose even sensitive data.<sup>198</sup>

### 3.3.2.4. Unsolicited rating

Particular problems arise in the context of unsolicited rating. This form of rating is not prohibited and is, according to statements of the national reporters, with the exception of the Netherlands,<sup>199</sup> practised everywhere, if admittedly not very often: as a response to strong criticism<sup>200</sup> of its previous practices, Moody’s announced in 2000 that, for the time being,

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<sup>190</sup> *Id.* Fundamental 3.4.

<sup>191</sup> *Id.* Fundamentals 1.9-1.10.

<sup>192</sup> *Id.* Fundamental 1.10.

<sup>193</sup> *Id.* Fundamental 1.7.

<sup>194</sup> *Id.* Fundamentals 1.11-1.16.

<sup>195</sup> *Id.* Fundamentals 3.11-3.18 as well as Sec. 15E(g) of the Securities Exchange Act 1934 as amended by the *Credit Rating Agency Duopoly Relief Act*, *supra* note 154.

<sup>196</sup> CESR, *supra* note 88, n. 133 *et seq.*; Habersack, *supra* note 15, at 196, n. 56.

<sup>197</sup> *Cf.* Habersack, *supra* note 15, at 198.

<sup>198</sup> Peters, *supra* note 3, p. 170.

<sup>199</sup> De Savornin Lohman & Van ‘t Westeinde (NL), *supra* note 17, ‘Introduction’, p. 2.

<sup>200</sup> Rousseau (CAN), *supra* note 26, II. A. 2. c) (ii), p. 25.

it did not intend to undertake any more unsolicited ratings; in the case of other CRAs, they constitute only an insignificant part of their business, accounting for less than 15% of all issuers rated.<sup>201</sup>

Here, the exertion of influence by the issuer is less of an issue than with a commissioned rating. Moreover, where numerous unsolicited ratings are undertaken simultaneously, the possibility of bringing transparency into otherwise opaque markets exists, as, in this manner alone, weak businesses will also be evaluated.<sup>202</sup> However, it must be taken into account that, without the cooperation of the issuer, recourse cannot usually be had to internal data, with the consequence that the CRA must then be satisfied with publicly accessible data. Although such a “public information rating” or “Q-Rating” may not necessarily be incorrect, at least its significance is limited.<sup>203</sup> Therefore, for the purposes of the Basel Accord, generally only contractual ratings are recognised.<sup>204</sup>

An additional problem arises from the fact that non-commissioned ratings, according to widespread perception, end up worse for the issuer than the usual interactive ratings.<sup>205</sup> Accordingly, the following message appears to be associated with the announcement of an unsolicited rating: in the future, a better rating and, thereby, continued existence on the market will only be able to be achieved with an interactive rating by the agency in question, which is obviously associated with costs. Consequently, CRAs could be tempted to increase their market share through the selective use of unsolicited ratings.<sup>206</sup> On the other hand, unsolicited ratings are often the only way for new agencies seeking to establish themselves on the market to draw attention to themselves and to build up a track record.<sup>207</sup> For this reason alone, a general prohibition of unsolicited ratings is not appropriate.<sup>208</sup>

However, the IOSCO provisions are to be endorsed to the extent that the limited information content of unsolicited ratings must be made known by disclosing at whose initiative the rating was made and from where the data has been obtained.<sup>209</sup> Furthermore, the issuer must be given the opportunity to communicate a more accurate portrayal of its business through its own cooperation. Such interactivity must remain free of charge.<sup>210</sup>

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<sup>201</sup> AMF, *supra* note 31, p. 16.

<sup>202</sup> *Signalling effect*, cf. Rousseau (CAN), *supra* note 26, II. A. 2. c) (ii), p. 25. Also the CRAs refer on this effect.

<sup>203</sup> CESR, *supra* note 88, n. 72.

<sup>204</sup> Basel Committee on Banking Supervision, *supra* note 52, n. 108.

<sup>205</sup> Particularly Moody's was reproached for doing so, cf. Rousseau (CAN), *supra* note 26, II. A. 2. c) (ii), p. 25 *et seq.* However, in this case, references to studies do not include empirical evidence.

<sup>206</sup> Pinto (US), *supra* note 25, at 344.

<sup>207</sup> Rousseau (CAN), *supra* note 26, II. A. 2. c) (ii), p. 26; CESR, *supra* note 88, n. 76.

<sup>208</sup> Also Habersack, *supra* note 15, at 199. Beyond this, a prohibition would not be constitutional in most countries; see Chaput (F), *supra* note 47, at 498.

<sup>209</sup> IOSCO, *supra* note 149, Fundamental 3.9.

<sup>210</sup> Also Habersack, *supra* note 15, at 199.

Finally, it goes without saying that the applicable competition laws must be applied in order to protect competitors, the issuers and unadulterated competition if it turns out that the unsolicited rating is being used as an instrument of power. The Basel Rules rightly provide for the revocation of ECAI status in such a case.<sup>211</sup>

### 3.3.3. Method of Implementation

Therefore, the IOSCO Code, with its emphasis on transparency and independence, follows the correct approach. However, difficulties are encountered in its implementation:

A simple “wait and see” approach relies on the market powers that are supposed to, of themselves, bring about implementation. It is not until this fails that more intensive measures will be considered. The Anglo-American approach can lay claim to not establishing any entry barriers and, thereby, promoting competition. In addition, for the time being, the practical consequences of the Code remain to be seen. However, this means that strong weight must then be placed on the “see”, as is done by the CESR and, above all, also by the French AMF. Attention must be paid to ensuring that the agencies do not merely make compliance declarations on paper, but rather, that they also actually follow the substantive regulations in practice. In its annual report of 2005, the AMF had already uncovered a number of substantive discrepancies amongst the large CRAs that had not been disclosed.<sup>212</sup> Moreover, a telephone survey undertaken by the author unearthed that numerous national CRAs in Germany have not only failed to publish a behavioural code, but also that the term itself was entirely unknown to the contact person at the CRA in question.

Thus, the situation cannot be brought under control without legal action;<sup>213</sup> in particular, the smaller CRAs will not be reached using the means employed up until now. A mere voluntary recognition procedure, as a reward for those agencies that intend to comply with the regulations, is also insufficient.<sup>214</sup> Rather, the behavioural requirements of credit rating agencies require binding legal force, especially because, at the same time, the credit ratings produced by them are being attributed with legal validity.<sup>215</sup>

One possibility would be to transform the Code provisions into national law using the Latin American model. It is obviously desirable to keep the regulations flexible; however,

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<sup>211</sup> Basel Committee on Banking Supervision, *supra* note 52, n. 108.

<sup>212</sup> AMF, Rapport 2005 sur les agences de notation, p. 9 *et seq.*, available at: [www.amf-france.org](http://www.amf-france.org) (update of 04/08/2006).

<sup>213</sup> Ebenroth & Daum, *supra* note 109, Supplement N° 5, p. 22; W. Däubler, *Wer kontrolliert die Rating-Agenturen?*, 2003 *Neue Juristische Wochenschau* (NJW) 1096 *et seq.*; Habersack, *supra* note 15, at 193 *et seq.*; *see also* the references cited in n. 215.

<sup>214</sup> Apparently dissenting is Emmenegger, *supra* note 26, at 41.

<sup>215</sup> P. v. Randow, *Rating und Regulierung*, in H. E. Büschgen & O. Everling, *supra* note 5, p. 543, at 560 *et seq.*, assuming that markets are normally able to self-regulate as long as there is no “Regulation by rating”. *See also* Fleischer, *supra* note 123, F 136; Sica (I), *supra* note 15, p. 11.

setting mere minimum standards, such as for recognition as ECAI or NRSRO, will not further the cause. Flexibility could be created by delegating the detailed legal drafting to a regulating body with expertise in the field,<sup>216</sup> such as is also foreseen under the *Credit Rating Agency Duopoly Relief Act*.<sup>217</sup> Alternatively, however, the Australian solution of making market access dependent on undertaking a voluntary obligation, in the form of a declaration of compliance, also appears attractive.<sup>218</sup> However, it goes without saying that existing acceptance on the market must not constitute a criterion for approval.<sup>219</sup> If this is observed, state licensing, due to the state guarantee of quality, could even result in making market entry easier if such licensing could, at least partially, restrict the significance of a CRA's track record as a means of quality assurance.<sup>220</sup>

The substantive regulations must be safeguarded through ongoing supervision. The competent authority must have the right to procure information and also be able to order a cessation of CRA activity in the event of an emergency. In this way, in addition to having a preventative and repressive effect, an instance of expert knowledge would be created at the same time.<sup>221</sup> However, importance must be placed on such an authority's independence from state instructions, as direct control of CRAs through an authority bound by instructions would only create new conflicts of interest since, indeed, the national states themselves can also be potential subjects of ratings. However, the initially most obvious alternative to this, namely, to establish an independent conciliation process,<sup>222</sup> may well fall short of the needs of practice, since a "negotiated rating" would not be accepted on the market.<sup>223</sup>

In light of the global character of the phenomenon, single-handed national approaches make little sense.<sup>224</sup> First of all, not much can thereby be achieved if the CRAs operate from abroad;<sup>225</sup> secondly, with solely national rules, the danger arises that the local financial economy may have a competitive disadvantage;<sup>226</sup> and, thirdly, the conflict of interest between the national legislature and CRAs mentioned above is only avoidable through international

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<sup>216</sup> Peters, *supra* note 3, p. 169.

<sup>217</sup> Sec. 15E of the Securities Exchange Act 1934 as amended by the Credit Rating Agency Duopoly Relief Act, *supra* note 154.

<sup>218</sup> Also Rousseau (CAN), *supra* note 26, 'Conclusion', p. 58.

<sup>219</sup> Self-evident for compulsory permission. This must apply even in the case of voluntary acceptance procedures: even if an acceptance is required for only parts of a market, (NRSRO, ECAI, n. 65), legal restrictions will be added to factual acceptance restrictions; dissenting is Emmenegger, *supra* note 26, at 39 *et seq.*

<sup>220</sup> Cf. CESR, *supra* note 88, n. 259.

<sup>221</sup> Peters, *supra* note 3, p. 166 *et seq.* refers to this fact.

<sup>222</sup> See Habersack, *supra* note 15, at 194.

<sup>223</sup> Discussion report on M. Habersack's reasoning at Kersting, *supra* note 130, at 243.

<sup>224</sup> See Chaput (F), *supra* note 47, at 500; AMF, *supra* note 31, p. 57 *et seq.*

<sup>225</sup> AMF, *supra* note 31, p. 4; see also Gortsos (GR), *supra* note 19, n. 9 and Trindade & Senn (CH), *supra* note 21, at 141.

<sup>226</sup> This is the perception in Italy, cf. Sica (I), *supra* note 15, p. 8 *et seq.*

consensus. In any case, in the European Union, the Community legislature is the appropriate regulatory body,<sup>227</sup> which has, indeed, already undertaken the regulation of other professions in the securities law sector.<sup>228</sup>

Finally, whether a regulation or licensing procedure should be supplemented by a legislative solution to the liability problem must also be considered. Liability claims are – as has been shown – mostly only enforceable with difficulty, if at all. Therefore, it would make a lot of sense for the legislator to allocate the risks of an erroneous evaluation between the parties by creating appropriate evidentiary rules, defining the appropriate standards of care, and potentially introducing capping limits.

#### 4. Theses

- 1) Credit Rating fulfils an important task in ensuring the integrity of the global financial markets.
- 2) Due to the enormous commercial and increasingly legal significance that rating evaluations have developed, Credit Rating Agencies have a potential for power that should not be underestimated.
- 3) In most legal systems, effective state control over CRAs occurs as rarely as a substantive regulation of their activities does. In this regard, nothing decisive will change during the course of the implementation of Basel II, as the criteria for recognition as an External Credit Assessment Institution merely set minimum standards.
- 4) Similarly elusive are special domestic laws upon which liability is based. Difficult legal questions arise in having recourse to claims under general civil and capital market laws. Above all, the enforceability of liability claims is endangered by considerable evidentiary problems.
- 5) In this way, the current legal approach to the rating phenomenon satisfies neither its factual nor its legal significance. An intensive analysis of the developments as in recent years was and remains necessary.
- 6) In order for rating agencies to fulfil their function, quality, reliability and independence of the rating agencies involved must be better guaranteed than has previously been the case. The market powers were unable to achieve this; therefore, regulatory action is necessary.
- 7) To a large extent, the content of the IOSCO Code is persuasive. However, in order to develop into effective rules, a legal framework is needed. Possible examples of such frameworks include the “American” way of regulating, or the “Australian” way of making a voluntary declaration upon entering the market.

Cite as: Uwe Blaurock, *Control and Responsibility of Credit Rating Agencies*, vol. 11.3 ELECTRONIC JOURNAL OF COMPARATIVE LAW, (December 2007), <<http://www.ejcl.org/113/article113-16.pdf>>.

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<sup>227</sup> This is the common opinion, *see* Habersack, *supra* note 15, at 194.

<sup>228</sup> *Cf.* the rules concerning financial analysts in Directive 2004/39/EC, *supra* note 56.