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**HOW THE THREAT OF HOLDING CREDIT RATING
AGENCIES LIABLE MIGHT INCREASE THE ACCURACY OF
THEIR RATINGS**

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I. INTRODUCTION AND PRELIMINARY CONSIDERATIONS

Credit rating agencies (CRAs) evaluate the creditworthiness of financial instruments or the issuers of such instruments.¹ They examine the risk that the payment of interests and capital will not, or not completely, take place at the promised time.² By rating financial instruments, CRAs help to reduce informational asymmetries between lenders and investors on one side and borrowers or issuers on the other side.³ Investors, who in most cases do not have the capacity or time to examine and evaluate the quality of financial instruments or the creditworthiness of the issuer of such instruments, use the ratings issued by CRAs to make investment decisions.⁴

Incorrect ratings of structured products contributed to the collapse of the subprime-mortgage market in the United States, which eventually led to the financial crisis.⁵ Deceived investors are increasingly trying to hold CRAs liable for the issuance of such flawed ratings.⁶ They often claim that the “issuer-pays model” was an

1. JOHN C. COFFEE, GATEKEEPERS: THE ROLE OF THE PROFESSIONS IN CORPORATE GOVERNANCE 283–84 (1st ed. 2006).

2. Eddy Wymeersch & Marc Kruithof, *Regulation and Liability of Credit Rating Agencies in Belgium*, in THE BELGIAN REPORTS AT THE CONGRESS OF UTRECHT OF THE INTERNATIONAL ACADEMY OF COMPARATIVE LAW 351 (Eric Dirix & Yves-Henri Leleu eds. 2006).

3. Harry McVea, *Credit Rating Agencies, The Subprime Mortgage Debacle and Global Governance: The EU Strikes Back*, 59 INT’L & COMP. L.Q. 701, 706–07 (2010); Frank Partnoy, *The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 628–38 (1999).

4. ALICE DARBELLAY, REGULATING CREDIT RATING AGENCIES 38 (1st ed. 2013); Wymeersch & Kruithof, *supra* note 2, at 353; *see also* Jan De Bruyne & Cedric Vanleenhove, *An EU Perspective on the Liability of Classification Societies, Selected Current Issues and Private International Law Aspects*, 20 J. INT’L. MAR. L. 103, 105 (2014).

5. *See* Nan S. Ellis, Lisa M. Fairchild & Francis D’Souza, *Is Imposing Liability on Credit Rating Agencies a Good Idea?: Credit Rating Agency Reform in the Aftermath of the Global Financial Crisis*, 17 STAN. J.L. BUS. & FIN. 175, 192–93 (2012).

6. *See Bathurst Reg’l Council v Local Gov’t Fin. Servs. Pty Ltd* [No. 5] [2012] FCA 1200 (Austl.), *aff’d sub nom. ABN AMRO Bank NV v Bathurst Reg’l Council* [2014] FCAFC 65 (Austl.) [hereinafter *Bathurst*] (accepting, for the first time that CRAs can have a duty of care towards investors notwithstanding the lack of a contract between both parties); *see also* Rommel Harding-Farrenberg & Kieran Donovan, *Duty of Care, Rating Agencies and the ‘Grotesquely Complicated’ Rembrandt: Bathurst Regional Council v Local Government Financial Services Pty Ltd* (No 5), 14 BUS. L. INT’L 185, 185–95 (2013) (discussing the

important cause of inadequate ratings. Moreover, so they argue, CRAs did not only rate securities but also helped issuers to structure them. CRAs advised issuers on the design of their securities to assure that they would qualify for the highest ratings. In turn, CRAs were given a fee that depended upon the success of the rated securities. This created conflicts of interest compromising the objectivity of CRAs and the quality of their ratings.⁷

Not surprisingly, the role and especially the liability of CRAs has recently attracted much attention from a policy⁸ and an academic point of view. Following the financial crisis, scholars have suggested a wide variety of measures to increase the quality⁹ and accuracy¹⁰ of ratings. Some of the most important and innovative proposals are briefly discussed in Part II. Each idea obviously has its own advantages and flaws. It would, however, lead me too far afield to extensively discuss the pros and cons of each suggestion, especially because several scholars advocating a particular reform generally start

Bathurst case in depth).

7. *See, e.g., In re Standard & Poor's Rating Agency Litig.*, 23 F. Supp. 3d 378 (S.D.N.Y. 2014); *Tolin v. Standard & Poor's Fin. Servs.*, 950 F. Supp. 2d 714 (S.D.N.Y. 2013); *Anschutz Corp. v. Merrill Lynch & Co. Inc.*, 785 F. Supp. 2d 799 (N.D. Cal. 2011); *Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.*, 651 F. Supp. 2d 155 (S.D.N.Y. 2009). *See generally* Lynn Bai, *On Regulating Conflict of Interests in the Credit Rating Industry*, 13 N.Y.U. J. LEGIS. & PUB. POL'Y 254, 263–65 (2010); Scott J. Boylan, *Will Credit Rating Agency Reforms be Effective?*, 20 J. FIN. REG. & COMPLIANCE 356, 362–63 (2012); John C. Coffee, *Ratings Reform: The Good, the Bad, and the Ugly*, 1 HARV. BUS. L. REV. 236, 254 (2010); Claire Hill, *Regulating Rating Agencies*, 82 WASH. U. L.Q. 43, 50–51 (2004) (discussing conflicts of interest and CRAs).

8. *See* Regulation 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, 2009 O.J. (L 302) 1; *see also* Iris H.Y. Chiu, *Regulating Credit Rating Agencies in the EU: In Search of a Coherent Regulatory Regime*, 271 EUROPEAN BUS. L. REV. 269, 278–94 (2014); Gudula Deipenbrock, *Trying or Failing Better Next Time?—The European Legal Framework on Credit Rating Agencies*, 271 EUROPEAN BUS. L. REV. 207, 207–25 (2014); Brigitte Haar, *Civil Liability of Credit Rating Agencies after CRA 3—Regulatory All-or-Nothing Approaches Between Immunity and Over-Deterrence*, 25 EUROPEAN BUS. L. REV. 315, 315–34 (2014); McVea, *supra* note 3, at 720–28.

9. *Quality*, OXFORDDICTIONARIES.COM, <http://www.oxforddictionaries.com/definition/english/quality> (last visited Feb. 7, 2016) (defining “quality” as the degree of excellence of something); *see also Quality*, BUSINESSDICTIONARY.COM, <http://businessdictionary.com/definition/quality.html> (last visited Feb. 7, 2016) (“In manufacturing, [‘quality’ is defined] as a measure of excellence or a state of being free from defects, deficiencies and significant variations brought about by strict and consistent commitment to certain standards that achieve uniformity of a product in order to satisfy specific customer or user requirements.”).

10. *See Accuracy*, OXFORDDICTIONARIES.COM, <http://www.oxforddictionaries.com/definition/english/accuracy> (last visited Feb. 7, 2016) (accuracy is defined as the “quality or state of being correct or precise” or the “degree to which the result of a measurement, calculation, or specification conforms to the correct value or a standard”).

by criticizing the existing practices and other proposals.¹¹

None of the suggestions to increase the quality of ratings seem convincing. Despite the sometimes very innovative ideas, Part III of the article relies on several arguments to conclude that the threat of civil liability and actual litigation against CRAs remains in prime position to guarantee that CRAs issue accurate ratings. The article concludes that the discussion in academic scholarship should no longer be whether CRAs have to face liability but should instead focus on the modalities of an appropriate liability regime for CRAs (e.g. strict or fault-based liability, capped, or unlimited liability).

II. IMPROVING THE QUALITY AND ACCURACY OF RATINGS – *STATUS QUESTIONIS*

Commentators have advocated several proposals to improve the accuracy of credit ratings. Firstly, an agency or entity established or supervised by the national government might minimize financial pressures that cause CRAs to issue flawed ratings.¹² Secondly, some scholars have advanced alternatives to the issuer-pays business model or have even claimed that re-establishing the once-existing investor-pays business model might increase the quality of ratings.¹³ Thirdly, financial or regulatory rewards and sanctions might be implemented to incentivize CRAs to issue accurate ratings.¹⁴ Fourthly, there have been more “radical” approaches and even suggestions to totally change the rules of the rating process.¹⁵ Finally, several other measures to improve the accuracy of ratings have been implemented both in the United States and in the European Union.¹⁶

11. See Coffee, *supra* note 7, at 251–66; Jack T. Gannon, *Let's Help the Credit Rating Agencies Get it Right: A Simple Way to Alleviate a Flawed Industry Model*, 31 REV. BANKING & FIN. L. 1015, 1037–41 (2012) (extensively discussing the benefits and disadvantages of several proposals); Claire Hill, *Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?*, 71 U. PITT. L. REV. 585, 602–07 (2010); Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91, 100–04 (2010).

12. See discussion *infra* Part II.A.

13. See discussion *infra* Part II.B.

14. See discussion *infra* Part II.C.

15. See discussion *infra* Part II.D.

16. See discussion *infra* Part II.E.

A. *Governmental & Supranational Supervised or Created Credit Rating Agencies*

Several commentators suggest that governments should establish a national or supranational rating agency. This approach views ratings as public goods issued to the benefit of the investing public and the economy in general.¹⁷

Gudzowski suggests two reasons that a federal government entity (the Agency) should take over the responsibilities of CRAs to rate mortgage securities. Firstly, under this approach, conflicts of interest with the issuer would be eschewed because the Agency would operate with general revenues. Issuers would still have to pay for the ratings but the payments would go to a general revenue fund and not directly to the Agency. As such, there would be no contact between the Agency and the issuer because the rating entity would no longer need to seek the business of the issuer (Incentive Advantages). Secondly, the Agency could increase transparency and uniformity. The Agency would not have any competitors and could, therefore, publically disclose its methods, models, and assumptions. Transparency allows outsiders (e.g. experts, academics, or investors) to “recreate step-by-step the Agency’s credit rating process”¹⁸ and criticize the decision-making process (Informational Advantages). This in turn might improve the rating models used by the Agency and increase the accuracy of its ratings.¹⁹

Bussani proposes an even more ambitious global strategy to ensure that CRAs issue accurate ratings. More specifically, he suggests placing the activities of CRAs under a “public international law umbrella.”²⁰ International institutions such as the International Monetary Fund (IMF) could set up an International Public Rating Agency (IPRA). The IPRA, surveyed by a Board whose members represent the world economies and financial markets, would then take over the activities of CRAs.²¹

Finally, Lynch proposes several ways to align the interests of

17. Listokin & Taibleson, *supra* note 11, at 102–03.

18. Milosz Gudzowski, *Mortgage Credit Ratings and the Financial Crisis: The Need for a State-Run Mortgage Security Credit Rating Agency*, 1 COLUM. BUS. L. REV. 101, 121 (2010).

19. *Id.* at 118–22.

20. Mauro Bussani, *Credit Rating Agencies’ Accountability: Short Notes on a Global Issue*, 10 GLOBAL JURIST 1, 12 (2010).

21. *Id.* at 12–13.

CRAs to the interest of the general public. For instance, the government could establish a taxpayer-funded agency that conducts and provides substantive risk analysis. The agency would use its resources to rate those securities and issuers that most adversely affect the general investing public. The agency would have to remain independent from political influence and should publically disclose its financial models, methodologies, procedures, assumptions, reports, and evaluations. This publically available information can subsequently be subject to public comments aiming to safeguard accurate ratings. The underlying idea is that a publically funded rating agency could overcome the existing issuer-pays business model which triggers CRAs to issue flawed ratings. The creation of a public agency, however, does not mean that private CRAs would disappear. Investors can still decide whether to use, interpret, and rely on ratings issued by private CRAs. In essence, the public agency only provides additional information, and it remains up to the investors to value the ratings, either those issued by the public agency or the private CRAs.²²

This idea of a public or government-operated CRA has not remained purely within the academic sphere. In 2013, German consulting firm Roland Berger proposed creating a European CRA to counter the dominance of the major CRAs, which are of American origin. However, this promising attempt failed because the initiators were not able to collect the €300,000,000 necessary for launching the project.²³

B. Alternatives to the Issuer-Pays Business Model

The existing issuer-pays business model leads to the remarkable situation where the issuer, whose creditworthiness is being controlled and rated, pays for these services.²⁴ This model has especially been criticized after the 2008 financial crisis due to potential conflicts of interest that can arise between the CRA and the issuer who is rated.²⁵ Research revealed that up to ninety-five percent of the CRA's annual

22. Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 291–99 (2009).

23. See, e.g., Nikolaj Nielsen, *EU-based credit rating agency buried*, EUOBSERVER (May 1, 2013, 9:25 AM), <http://EUobserver.com/foreign/120005>.

24. Lawrence J. White, *Credit-rating agencies and the Financial Crisis: Less Regulation of CRAs is a Better Response*, 25 J. INT'L. BANKING L. & REG. 170, 170, 173 (2010).

25. See, e.g., Bai, *supra* note 7, at 263–65; Benjamin J. Kormos, *Quis custodiet ipsos custodes? Revisiting Rating Agency Regulation*, 4 INT'L. BUS. L.J. 569, 575–79 (2008);.

revenues comes from fees paid by issuers.²⁶ CRAs are required and expected to give an independent rating on the issuer's creditworthiness, while at the same time being economically dependent upon the very same issuer. The question arises whether CRAs can really remain independent from the rated entity under these circumstances. There is an inherent risk that CRAs systematically assign a higher rating to an issuer in order to increase their revenues from the latter.²⁷ Phrased differently, CRAs have financial incentives to generate reports that please the issuers.²⁸ At the same time, issuers have the possibility to "shop around" for ratings and choose the CRA that assigns the highest rating or that uses less strict standards to achieve the desired rating.²⁹

This conflict of interest seems even more acute when CRAs rate structured finance products considering the volume of deals and the corresponding rating business attributable to those transactions. Structured finance ratings were one of the fastest growing income streams for the major CRAs. As such, CRAs might be less inclined to use appropriate conservative and safe assumptions in their methodologies in order to maintain transaction flows.³⁰

CRAs counter this argument by pointing out that they face reputational pressure to issue accurate ratings. A CRA would lose credibility in the eyes of investors if it only issued favorable ratings because of the positive influence this might have on the rating fee. Such conduct would harm the reputation of the CRA and could even lead to its collapse. Investors would not rely on a CRA's credit ratings if it did not give a true independent opinion of the issuer's creditworthiness. In essence, CRAs put their reputation at stake each time they issue ratings and, therefore, will do everything within their power to make sure that the ratings are independent opinions.³¹

26. Partnoy, *supra* note 3, at 652.

27. Bai, *supra* note 7, at 263–64.

28. Boylan, *supra* note 7, at 362–63.

29. White, *supra* note 24, at 173; EFRAIM BENMELECH & JENNIFER DLUGOSZ, *The Credit Rating Crisis* 16–21 (Nat'l Bureau of Econ. Research, Working Paper No. 15045, June 2009).

30. TECH. COMM. OF THE INT'L ORG. OF SEC. ORG., *THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS* 12 (2008).

31. See, e.g., Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1 (2002) (concluding that CRAs are already motivated to provide accurate ratings because their profitability is directly tied to their reputation); Vickie Tillman, *Don't Blame the Rating Agencies*, WALL ST. J. (Aug. 31, 2007), <http://www.wsj.com/articles/S B118852499512414246> (stressing that reputation and integrity

The reputation argument, however, is not as convincing as it seems at first sight to guarantee that CRAs issue accurate ratings.³² Some scholars have proposed alternatives to the issuer-pays business model or claimed that re-establishing the once-existing investor-pays business model might increase the quality of ratings. The following paragraphs briefly shed light on some of these proposals.

The Senator Franken proposal³³ provides for the creation of a Credit Rating Agency Board (the Board) which would be driven by investors and under supervision of the U.S. Securities and Exchange Commission (SEC). The Board would assign the issuers who want to sell financial products and need an initial rating to a particular Nationally Recognized Statistical Rating Organization (NRSRO). The Board would not issue the rating but would only assign an issuer to a rating agency to prevent the former from shopping for the highest rating.³⁴ The proposal also obligates the SEC to place a reasonable ceiling on the rating fees charged by the CRAs. The issuer would remain free to solicit additional ratings once it obtained a mandatory rating.³⁵ The ambitious Franken Proposal was not adopted. Rather, Section 939F of the Dodd–Frank Act only requires the SEC to conduct a study on the feasibility of the proposal.³⁶

Several alternatives, all aiming to strengthen or complement the Franken proposal, have been suggested. Horner, for instance, suggests establishing an independent committee (Board) composed either of SEC personnel, experts from NRSROs or institutional investors. The rating process would also need substantial changes and start with the issuer selecting the CRA (Hired CRA). The issuer would have to send the Hired CRA's analysis to the Board together with a standard fee.

are the most valuable long-term assets that would make it imprudent for CRAs to give anything other than fair, objective, and independent ratings).

32. See, e.g., Lynch, *supra* note 22, at 250–67 (for further references); Partnoy, *supra* note 3, at 654–81; Jérôme Mathis, James J. McAndrews & Jean-Charles Rochet, *Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?*, 56 J. MONETARY ECON. 657, 657–674 (2009).

33. See Amendment to Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong., 156 Cong. Rec. 3648, 3648–60 (2010).

34. See *id.*

35. See Coffee, *supra* note 7, at 256; Olivia Schmid, *Rebuilding the Fallen House of Cards: A New Approach to Regulating Credit Rating Agencies*, 3 COLUM. BUS. L. REV. 994, 1018–19 (2012).

36. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, § 939F(d), 124 Stat. 1376, 1889–90 (2010) (codified at 15 U.S.C. § 78o–9); see also TRADING & MRTS. DIV., U.S. SEC. & EXCH. COMM'N, REPORT TO CONGRESS ON ASSIGNED CREDIT RATINGS (2012).

The Board would subsequently have to submit the analysis to two other NRSROs (Review NRSROs). These Review NRSROs could not be solicited by the issuer for consulting, advisory, or rating services. The Board will only approve the rating given by the Hired CRA if both Review NRSROs conclude that the analysis of the Hired CRA and the given rating are reasonable (e.g. based on the inputs and methodologies used in calculating the credit rating). The Board, on the other hand, will downgrade the Hired CRA's rating one degree (e.g. from AAA to AA) if at least one Review NRSRO finds the analysis of the Hired CRA unreasonable. Importantly, the two Review NRSROs cannot incur liability for reviewing the analysis. The liability remains solely with the Hired CRA, although the Review NRSROs can face a financial penalty if they act in bad faith when conducting their review.³⁷

According to Lynch, conflicts of interest can be minimized if the government hires private CRAs to rate securities.³⁸ Public funds could be used to hire private CRAs “that shun the issuer-pays revenue model or, as a result of government funding, are willing to move away from the issuer-pays model to conduct credit analysis on selected securities.”³⁹ In other words, the public would pay the CRAs for the rating services. Ratings issued by government hired CRAs might have additional informational value for investors. The hired CRAs will probably issue “overly conservative”⁴⁰ ratings based on credit evaluations which are more oriented toward protecting the investing public. The government might favor such conservatism and will more likely contract with CRAs that use investor-friendly and less risky rating methodologies. In sum, in addition to the ratings issued by private CRAs, investors could also consider the ratings provided by the hired CRAs when making their investment decisions.⁴¹

Grundfest and Hochenberg urge the SEC to create a new category of agency, namely the Investor Owned and Controlled Rating Agencies (IOCRAs).⁴² The IOCRAs would have to be under

37. Nicholas D. Horner, *If You Rate It, He Will Come: Why Uncle Sam's Recent Intervention with the Credit Rating Agencies was Inevitable and Suggestions for Future Reform*, 41 FLA. ST. U. L. REV. 489, 506–08 (2014).

38. Lynch, *supra* note 22, at 300.

39. *Id.* at 300.

40. *Id.*

41. *Id.* at 300–01.

42. Joseph Grundfest & Evgeniya E. Hochenberg, *Investor Owned and Controlled*

control of the sophisticated investor community. As such, the IOCRAs are oriented towards generating ratings that accurately reflect the credit risk. Every rating issued by a rating agency that is not an IOCRA such as Moody's and Standard & Poor's (S&P) should be accompanied by at least one rating issued by an IOCRA. Although issuers will still pay for the credit ratings, IOCRAs represent the investors' interest and if they would "fail to spot systematic rating inflation by the sell side, then the investment community will have only itself to blame."⁴³

Finally, Manns notes that purchasers of debt currently do not play any role in the rating process.⁴⁴ Under the current model, purchasers do not always have the possibility to hold CRAs liable. Purchasers should bear the burdens as well as benefits of holding CRAs liable by financing a user's fee system administered by the SEC. In exchange for paying the fee, purchasers should be given enforceable rights against CRAs. The SEC would use the profits of such a user fee to finance the bidding process in which CRAs compete to rate the issuer's debt. The bidding CRAs would be required to detail the type and extent of diligence they will undertake. CRAs would have certification and mandatory reporting duties toward purchasers. These requirements provide CRAs with more clear responsibilities in overseeing issuer disclosures. For example, CRAs could certify on a quarterly basis that they have exercised reasonable care in conducting a due diligence assessment of the issuer's financial and nonfinancial disclosures to make accurate assessments of risk exposure. This in turn gives purchasers the possibility to hold CRAs liable when they violate such duties. However, the liability of CRAs toward purchasers should be limited to cases of gross negligence and capped to a percentage of their annual rating fees. In addition to the possibility for purchasers to file claims against CRAs, the SEC should be able to pursue actions when CRAs negligently breach their reporting duties.⁴⁵

Rating Agencies: A Summary Introduction 6 (Stanford Law & Econ., Olin Working Paper No. 391, Oct. 2009).

43. *Id.*

44. Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1059–89 (2009).

45. *Id.*

C. Conditioning “Pavlovian” CRAs Through Rewards and Sanctions

Some scholars opt for another approach and argue that financial or regulatory rewards or sanctions might incentivize CRAs to issue accurate ratings. These proposals often have a quasi-strict liability component since CRAs could be sanctioned if it turns out that their ratings are inaccurate.⁴⁶

The reputation of CRAs does not necessarily make them issue accurate ratings for new products. CRAs have nothing to lose when they charge high rating fees and simultaneously issue low-quality ratings for new products. Even if low-quality ratings for new product types might harm their reputation when it comes to rating other product types, CRAs will keep issuing flawed ratings as long as new products are large enough in volume. Rational investors will rely on ratings for new products as long as the rating quality is high enough on average, even if they know that some of the ratings might be of low quality. CRAs should be required to disgorge the profits they receive from inaccurate ratings of new products that fall under a predetermined quality level, unless the CRAs themselves disclose that the ratings are of low quality.⁴⁷

Harris argues that the profits for CRAs should rise if the bonds they rate as investment grade perform well and decrease if those bonds default. CRAs could create this scheme by placing a meaningful portion of their fees into escrow. The custody of these funds would return to CRAs if their ratings performed well.⁴⁸ The concentration in the rating market, coupled with the issuer-pays business model, reduces the incentive for CRAs to compete and issue accurate ratings.⁴⁹ To combat this phenomenon, a mandatory “pay-for-performance compensation scheme” could be established in which a fixed percentage of accrued revenue earned by the largest rating agencies would be ceded to fund a performance bonus. Regulators

46. Deryn Darcy, *Credit Rating Agencies and the Credit Crisis: How the “Issuer Pays” Conflict Contributed and What Regulators Might Do About It*, 2 COLUM. BUS. L. REV. 605, 662 (2009).

47. John P. Hunt, *Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 1 COLUM. BUS. L. REV. 109, 181–82 (2009).

48. Larry Harris, *Pay the Rating Agencies According to Results*, FIN. TIMES (June 3, 2010), <http://www.ft.com/intl/cms/s/0/a2d8d710-6f3d-11df-9f43-00144feabdc0.html#axzz3S5Llw6zr>.

49. Robert J. Rhee, *On Duopoly and Compensation Games in the Credit Rating Industry*, 108 NW. U. L. REV. 85, 89 (2013).

could award the bonus at periodic intervals on a winner-take-all basis to the best performing CRA for a given period.⁵⁰

According to Coffee, CRAs should have their NRSRO designation taken away for a particular asset class if they issued flawed ratings. Under this approach, the SEC would define a maximum default rate for each letter grade rating and should measure compliance with this standard separately for corporate bonds and structured finance products. The SEC would revoke the NRSRO status given to a CRA whose default rate for any particular product exceeds these parameters over a defined period. Consequently, institutional investors would still consider the credit rating but would no longer rely on it when determining the legality of an investment decision (which requires a credit rating issued by an NRSRO). The NRSRO suspension should continue until the CRA's five-year default rate is again within the acceptable SEC parameters for that rating.⁵¹

An incentive compensation scheme has also been suggested by Listokin and Taibleson. According to this scheme, CRAs would be paid incrementally over time with the debt they rate instead of immediately receiving a rating fee. This way, the cost of inflating the value of rated securities would fall on the CRA. The authors use the example of a CRA that decides to rate the issuer's debt for a contractual agreed fee of \$500. The value of the payments to the CRA depends on both the probability that the debt defaults as well as the general rate at which investors are willing to supply capital for repayment the next year. Assume, for instance, that each unit of issued debt pays \$1 back in the next year. Consider now that the markets value \$1 at \$0.90 in the next year for debt given a AAA rating and at \$0.80 for debt rated BBB because of higher probability of default. This implies that each unit of the issuer's debt (paying \$1 in one year) is worth \$0.90 if the CRA gives a AAA rating. The CRA, therefore, should receive 555.56 units of debt ($\$500/\0.90) as a rating fee if the CRA gives a AAA rating. If the CRA, on the other hand, gives a BBB rating, each unit of debt is worth \$0.80. As a consequence, the CRA is given 625 units of debt ($\$500/\0.80) as a rating fee when it provides a BBB rating.⁵²

50. *Id.*

51. The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets: Hearing Before the S. Banking Comm., 110th Cong. (2007) (testimony of John C. Coffee, Professor of Law, Columbia University Law School).

52. Listokin & Taibleson, *supra* note 11, at 104–06.

Under the current issuer-pays business model, a CRA might give an AAA rating to debt which actually has a default probability of a BBB rating. The issuer might shop around and contract with the CRA that issues the most favorable AAA rating instead of the CRA that issues a lower but more accurate BBB rating. The debt compensation scheme advocated by Listokin and Taibleson overcomes this problem. Going back to the example, the CRA receives 555.56 units of debt if it rates the debt as AAA. However, at market prices, the debt is only worth \$444.40 (555.56 x \$0.80). As a consequence, the CRA has a strong incentive to rate the debt as BBB (the actual default probability). With this accurate rating, the CRA receives 625 units of debt. This means that the true value of the fee will correspond to the contractual agreed fee of \$500 (625 x \$0.80). In essence, the CRA will suffer a financial penalty when it overrates debt because the debt the CRA receives as compensation is less valuable than the cash compensation that the debt is replacing.⁵³

Some seek criminal penalties to make CRAs issue accurate ratings. According to Maas, for instance, criminal law is more efficient and effective than a purely civil regulatory regime to ensure that CRAs issue accurate ratings. More specifically, a tailored criminal law targeting CRAs provides a justifiable and powerful mechanism to punish high-risk misconduct.⁵⁴ CRAs should, therefore,

53. *Id.*

54. David A. Maas, *Policing the Ratings Agencies: The Case for Stronger Criminal Disincentives in the Credit Rating Market*, 101 J. CRIM. L. & CRIMINOLOGY 1005, 1005–38 (2013). Professor Maas suggests the following criminal law provisions for CRAs:

Title I—Credit Ratings Accountability

§ 1.01 Management Accountability

(1) All credit ratings provided by a Nationally Recognized Statistical Rating Organization must be approved by two personnel, including at least one management-level individual.

(2) Nationally Recognized Statistical Rating Organizations must keep records of which personnel certified each credit rating for a period not less than 10 years.

Title II—Criminal Credit Rating Fraud

§ 2.01 Criminal Credit Rating Fraud

Whoever recklessly certifies, or attempts to certify a falsely inflated or falsely depressed credit rating to be published by a Nationally Recognized Statistical Rating Organization shall be criminally fined or imprisoned not more than 15 years, or both.

Id. at 1028.

be subject to criminal punishment, even absent knowledge or intent, if they commit any misconduct.⁵⁵

Finally, Gannon argues that conflicts of interest and thus potentially inaccurate ratings can be reduced by a tax deduction. Such a tax deduction provides CRAs with a direct financial incentive to accurately rate products. The model, however, needs to have three components if it is to be properly implemented. Firstly, the amount of the tax deduction should equal the rating fee. Secondly, a threshold line needs to be drawn within the rating spectrum to determine which credit ratings qualify for the deduction. The line should be set at the investment's grade, meaning that only securities rated below investment grade would be eligible for the deduction. Thirdly, eligible securities that default would result in a deduction if the security was rated below the investment grade prior to default. In other words, the rating needs to be accurate for a certain time before the default occurs if it wants to be eligible for a tax deduction.⁵⁶

D. Modifying the Rules of the Credit Rating Game

Other scholars have proposed more radical approaches or even suggested a total change of the rules of the rating game. The following paragraphs briefly shed light on two of the most innovative ideas.

For example, Schmid suggests a three-step reform to overcome conflicts of interest that generate inaccurate ratings. Firstly, issuers should obtain a vote from their largest institutional investors, the outcome of which determines the CRA that the issuer has to hire. The issuer would still have to pay the CRA, but the model reduces potential conflicts of interest, because the most significant institutional investors will select the CRA. Only bonafide investors, those who are truly interested in purchasing the debt, should be able to vote. The CRAs among which investors can choose should be

55. *Id.* at 1005–38; *see also* Nan S. Ellis & Steven B. Dow, Attaching Criminal Liability to Credit Rating Agencies: Use of the Corporate Ethos Theory of Criminal Liability, 17 J. BUS. L. 167, 172 (2014) (referring to Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095, 1099 (1991)). The corporate ethos model is based on the belief that organizations possess an identity that is independent of specific individuals who control or work for the organization; corporate criminal liability is appropriate if the government can prove that the corporate ethos encouraged corporate employees to engage in wrongdoing.

56. Gannon, *supra* note 11, at 1042–44; *see also* Lynch, *supra* note 22, at 301–02 (presenting another tax proposal).

limited to NRSROs, which investors subsequently need to anonymously rank by preferences. Points should be allocated to each NRSRO of the investor's choice with their first choice receiving the greatest number of points. The CRA with the highest number of cumulative points from all the participating investors "will win the rating contract."⁵⁷

Secondly, investors need to have access to information in order to compare the different CRAs and select the one they want to hire. A government-operated agency or, even more appropriate, a self-regulatory organization can facilitate this decision-making process. Such "rater[s] of rating agencies"⁵⁸ will have to evaluate and rank the performance of individual CRAs. This ranking should be based on different metrics such as the CRAs' performance statistics or the frequency with which ratings are updated or reaffirmed. The idea is that the ranking of performance might trigger CRAs to issue accurate ratings.⁵⁹

Thirdly, a step of last resort remains necessary if the two previous requirements do not lead to a market that sufficiently penalizes inaccurate ratings. CRAs that are not ranked in the top three by the governmental agency or self-regulatory organization will be given a "low performance" designation. Issuers are required to obtain a second rating from a better performing CRA when they choose to hire a low-performing agency. Consequently, CRAs with a performance that is below an acceptable level of accuracy remain out of business because issuers face two choices. They can either hire the less efficient CRA but with the additional cost of obtaining a second rating or immediately choose the more efficient CRA without any added cost.⁶⁰

Another creative idea has been forwarded by Hosp who was inspired by a game of golf for his theory on "handicapping" CRAs. A handicap in golf refers to the numerical advantage given or disadvantage imposed to account for past performance.⁶¹ The purpose of the handicap is to create a level playing field between golfers of different skill levels. It is accomplished by giving the less skilled

57. Schmid, *supra* note 35, at 1032.

58. *Id.* at 1034.

59. *Id.* at 1033–39.

60. *Id.* at 1039–43.

61. Phillip Hosp, *Problems and Reforms in Mortgage-Backed Securities: Handicapping the Credit Rating Agencies*, 79 *MISS. L.J.* 531, 570 (2010).

golfers a scoring advantage over their competitors. The size of the advantage is determined by the difference between the two golfers' playing ability. When applying this to CRAs, the SEC should create "CRA handicaps" that predict the likelihood of an issuer's credit rating.⁶²

The information used to calculate the future performance would consist of information that is currently required to be disclosed (e.g. accuracy of past ratings issued or the timeliness of downgrades). Once the handicap of a CRA is determined, the SEC needs to incorporate it into the regulatory structure by adjusting ratings according to the CRA's handicap. As such, the CRA's past performance needs to be tied with the regulatory benefits derived from its rating. Hosp clarifies his proposal with a simple example. Suppose that the issuer hires a particular CRA to rate a mortgage-backed security. The CRA issues an AA rating, which is considered the gross or unadjusted credit rating. The SEC subsequently applies the CRA's handicap to determine the net or adjusted rating. If the CRA has a bad track record in rating other mortgage-backed securities or failed to timely downgrade its ratings in the past, the handicap calculated by the SEC could reduce the gross rating from AA to the net rating A or lower if appropriate.⁶³

E. Other Reforms—Increasing Competition, Disclosure Requirements, Managing Conflicts of Interest, Regulatory License Model, and Liability for CRAs

None of the above mentioned suggestions to improve the quality of ratings, especially the more drastic ones that want to change the rules of the rating game, have been adopted by national legislators. Five other measures to improve the accuracy of ratings, on the other hand, have been implemented both in the U.S. and in the EU: increasing competition in the credit-rating market,⁶⁴ extensive disclosure requirements,⁶⁵ managing and minimizing conflicts of interest,⁶⁶ reducing regulatory dependency on ratings,⁶⁷ and

62. *Id.* at 570–71.

63. *Id.* at 569–72.

64. *See infra* Part A.

65. *See infra* Part B.

66. *See infra* Part C.

67. *See infra* Part D.

threatening to hold CRAs liable for inaccurate ratings.⁶⁸

1. Increasing Competition in the Rating Sector

Firstly, several scholars have argued that more competition in the rating sector, which is dominated by Moody's, Fitch and S&P, would make CRAs issue more accurate ratings.⁶⁹ As a response, the United States Congress adopted the Credit Rating Agency Reform Act (CRARA) in 2006. The Act aims to improve the quality of ratings by fostering accountability, transparency, and competition in the rating industry. More specifically, the barriers for CRAs to get NRSRO designation were lowered. The CRARA established "substantively undemanding"⁷⁰ registration criteria aiming for more CRAs to apply for NRSRO designation and boost competition in the rating sector.⁷¹

In the EU, Regulation 462/2013 on CRAs also contains several provisions that aim to increase competition in the rating market. For instance, where two or more ratings are sought, the issuer should consider appointing at least one smaller CRA that does not have more than ten percent of the total market share and which could be evaluated by the issuer as capable of rating the relevant product or issuer.⁷² Moreover, the issuer needs to set up a rotation mechanism of CRAs which rate re-securitizations. Although there is only a limited number of CRAs active in the rating market for re-securitizations, that market is more naturally open to competition and a rotation mechanism could be a driver for creating more dynamics. Such a rotation of CRAs should bring more diversity to the assessment of

68. See *infra* Part E.

69. See, e.g., Gannon, *supra* note 11, at 1041 (urging the SEC to allow small or new NRSROs "to get their feet under them by relaxing certain rules for these entities"); Hill, *supra* note 7, at 85 ("My proposal is gradually to increase the number of NRSROs and revisit the issue of eliminating the NRSRO designation in five years."); Rhee, *supra* note 49, at 93 (identifying the lack of competition in the rating sector as one cause for the poor performances by CRAs—the rating market is heavily concentrated with Moody's and S&P dominating the market as a duopoly plus Fitch as a major player).

70. Hunt, *supra* note 47, at 134.

71. See Credit Rating Agency Reform Act of 2006, Pub. L. 109–291, § 15E, 120 Stat. 1327, 1329–1338 (2006) (codified at 15 U.S.C. § 78o–7); see also Marilyn Blumberg Cane et al., *Below Investment Grade and Above the Law: A Past, Present and Future Look at the Accountability of Credit Rating Agencies*, 17 *FORDHAM J. CORP. & FIN. L.* 1063, 1084–86 (2012); Coffee, *supra* note 7, at 246–48 (discussing boosting competition in the rating sector); Hunt, *supra* note 47, at 131–38; Listokin & Taibleson, *supra* note 11, at 100–01.

72. See Regulation 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation 1060/2009 on Credit Rating Agencies, recital 11, 2013 O.J. (L 146) 1, 3.

creditworthiness. Multiple and different views, perspectives, and methodologies applied by CRAs should produce more diverse credit ratings and ultimately improve the assessment of the creditworthiness of re-securitizations.⁷³ Finally, in order to mitigate conflicts of interest and facilitate fair competition in the rating market, the fees charged by CRAs to their clients should not be discriminatory.⁷⁴

2. Disclosure Requirements for CRAs

Secondly, extensive disclosure requirements for CRAs could lead to more accurate credit ratings. Making such information available allows other CRAs to provide unsolicited ratings and enables investors to evaluate the CRAs' performances. The disclosure of the relevant information on a particular security gives investors the opportunity to perform their own analysis of the rated securities. Investors are thus able to "appropriately figuratively price or discount the ratings' informational value, and consequently, better price debt and debt-like securities."⁷⁵ As a consequence, CRAs might become aware that investors can control the quality of ratings, which then operates as a sort of hanging hammer. These mechanisms will trigger CRAs to issue accurate ratings. In other words, CRAs would refrain from issuing flawed ratings because investors can second-guess the rating.⁷⁶

The CRARA and the Dodd–Frank Act require CRAs to disclose *inter alia* conflicts of interest, information relating to the assumptions underlying the rating procedures and methodologies, prior rating errors made, the data relied upon to determine the rating, and the main assumptions and principles used to construct procedures or methodologies, including qualitative methodologies and quantitative inputs.⁷⁷ Additional SEC rules require CRAs (1) to disclose policies regarding whether, and if so how, information used in ratings is

73. *Id.* at 3–4, 15–16 (recitals 14, 15, and 16, and amendments to Article 6b).

74. *Id.* at 8, 24 (Recital 38 and Annex I(1)(c)).

75. Lynch, *supra* note 22, at 275.

76. Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111, 1147 (2009) (arguing that (1) NRSROs should also be required to disclose a summary of the material information that was used in deriving the rating and reveal exactly what type of loan-level data was relied upon giving the investor the opportunity to evaluate the limitations of the rating and (2) NRSROs should also disclose any sources used to verify the information relied upon in determining the rating and the assumptions made in determining a particular rating). *Contra* Darcy, *supra* note 46, at 653–58 (arguing that disclosure alone is insufficient to deter CRAs from issuing inaccurate ratings).

77. See Dodd–Frank Act, Pub. L. 111–203, § 932, 124 Stat. 1376, 1880 (2010).

verified, (2) to document any model adjustments made to ratings, and (3) to disclose how frequently they review their ratings.⁷⁸

The EU Regulation on CRAs also contains several disclosure requirements. CRAs, for instance, are required to publically disclose conflicts of interest, their rating methodologies or models and key rating assumptions used in rating activities.⁷⁹ According to the Regulation, the ability of investors to make an informed assessment of the creditworthiness of structured finance instruments is improved if they are given sufficient information on those instruments. Considering that the risk on structured finance instruments to a large extent depends on the quality and performance of the underlying assets, investors should be provided with more information on the underlying assets. This would reduce investors' dependence on ratings. Moreover, disclosing relevant information on structured finance instruments is likely to reinforce the competition between CRAs because it could lead to an increase in the number of unsolicited ratings.⁸⁰

3. Managing Conflicts of Interest with the Issuer

Thirdly, it has already been mentioned that investors alleged that conflicts of interest were one of the main reasons why CRAs issued inaccurate ratings for mortgage-backed securities.⁸¹ Legislators in the US and EU have adopted several provisions to prevent conflicts of interest from arising between the issuer and CRAs.

In the EU, Regulation 1060/2009 on CRAs and subsequent amendments contain several requirements to ensure that CRAs remain independent from the rated entity. More particularly, CRAs have to implement measures at the personal level, at the agency level, and if they have fifty or more employees, in their corporate governance.⁸² CRAs have to take all necessary measures to guarantee that the

78. See Dennis, *supra* note 76, at 1145–46 (referencing specific SEC rules).

79. Regulation 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, tit. II, art. 8, 2009 O.J. (L 302) 1, 12.

80. Regulation 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation 1060/2009 on Credit Rating Agencies, recital 30, 2013 O.J. (L 146) 1, 7.

81. See *supra* note 7 (references to case law); see also *infra* Part 3.1 (cases dealing with the protection given to ratings under the First Amendment). But see DANIEL M. COVITZ & PAUL HARRISON, TESTING CONFLICTS OF INTEREST AT BOND RATINGS AGENCIES WITH MARKET ANTICIPATION: EVIDENCE THAT REPUTATION INCENTIVES DOMINATE (2003) (suggesting that conflicts of interest do not influence the conduct of CRAs).

82. Chiu, *supra* note 8, at 282–84.

issuing of a rating is not affected by a potential conflict of interest. This implies that the rating process may not be impaired by a business or personal relationship involving the CRA, its managers or its rating analysts.⁸³ Rating analysts and other persons who are directly involved in rating activities are not allowed to initiate or participate in negotiations regarding fees with any rated entity or any person that is directly or indirectly linked to the rated entity.⁸⁴ Furthermore, the compensation and performance evaluation of rating analysts may not be contingent on the amount of revenue that the CRA derives from the rated entities or their products.⁸⁵

Section A of Annex I of the Regulation also contains organizational requirements to enhance the independence of CRAs and avoid conflicts of interest. For instance, the senior management has to ensure that the rating agency's activities are independent from all political and economic influences or constraints. Moreover, conflicts of interest need to be properly identified, managed, and disclosed.⁸⁶ A CRA has to be organized in such a way that its business interest does not impair the independence or accuracy of rating activities. In addition, they have to establish appropriate and effective organizational and administrative arrangements to prevent, identify, eliminate, or manage and disclose any conflict of interest.⁸⁷

The operational requirements listed in Section B of Annex I of the Regulation also aim to eliminate conflicts of interest. CRAs have to clearly and prominently disclose any actual or potential conflict of interest that may influence the assessment and judgments of their rating analysts.⁸⁸ CRAs are also asked to make public the names of rated entities or related third parties from which they receive more than five percent of their annual revenue.⁸⁹ Except for certain circumstances, CRAs are not authorized to issue a rating.⁹⁰

Long-lasting relationships with the same rated entity could compromise the independence of analysts approving ratings. Therefore, CRAs have to establish a gradual and appropriate rotation

83. Regulation 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, tit. II, art. 6, 2009 O.J. (L 302) 1, 12.

84. *Id.* (Article 7(2)).

85. *Id.*

86. *Id.* at 23 (Annex I, § A(1)).

87. *Id.* at 24 (Annex I, § A(7)).

88. *Id.* at 25 (Annex I, § B(1)).

89. *Id.* at 25 (Annex I, § B(2)).

90. *Id.* at 25 (Annex I, § B(3)).

mechanism.⁹¹ In this regard, lead rating analysts may not be involved in rating activities on the same entity for a period exceeding four years. Similarly, people who approve ratings shall not be involved in rating activities related to the same rated entity for a period exceeding seven years.⁹² Regulation 462/2013 imposes additional rotation requirements for CRAs when rating structured finance instruments. An issuer who intends to issue structured financial products is, for example, required to appoint at least two CRAs to provide ratings independently from each other.⁹³

Moreover, when CRAs enter into a contract for issuing ratings on re-securitizations, they are not allowed to issue ratings on new re-securitizations with underlying assets from the same originator for a period exceeding four years. As from the expiration of the rating, CRAs are prohibited to enter into a new contract for the issuing of ratings on re-securitizations with underlying assets from the same originator for a period equal to the duration of the expired contract but not exceeding four years.⁹⁴ CRAs also have to use different rating categories and symbols for structured finance to clearly distinguish them from other products.⁹⁵ Finally, the rating has to include all information about the loss and cash-flow analysis that CRAs have performed or are relying upon as well as an indication of any expected change in the rating. Ratings of structured finance products have to include guidance materials explaining the assumptions, parameters, limits, and uncertainties surrounding the methodologies and models used for such ratings.⁹⁶

The Regulation on CRAs also includes several provisions both to reduce the involvement of CRAs in the design of structured finance and to restrict the offer of additional consulting services. Rating analysts or people who approve ratings are not allowed to make proposals or recommendations, either formally or informally, on the design of the structured finance instruments that the CRA is expected

91. *Id.* at 4, 12 (recital 33 and Article 7(4)).

92. *Id.* at 27 (Annex I, § C(8)).

93. Regulation 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation 1060/2009 on Credit Rating Agencies, art. 1, 2013 O.J. (L 146) 1, 11; *id.* at 18 (Article 8c).

94. *Id.* at 15 (Article 6b)

95. Regulation 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, art. 10(3), 2009 O.J. (L 302) 1, 13.

96. *Id.* at 31 (Annex II).

to rate.⁹⁷ Moreover, CRAs or any person holding directly or indirectly at least five percent of either the capital or voting rights of the CRA (or who is in a position to exercise significant influence on the business activities of the CRA) are not allowed to provide consultancy or advisory services to the rated entity with regard to its corporate or legal structure, assets, liabilities, or activities. Although CRAs may offer certain ancillary consulting services (e.g. market forecasts, estimates of economic trends, or pricing analysis), they must always ensure that this does not cause conflicts of interest with their rating activities.⁹⁸ Finally, CRAs have to keep adequate records and, where appropriate, audit trails of their credit-rating activities. Such records need to include information related to fees received from any rated entity and the procedures and methodologies that CRAs use to determine the ratings.⁹⁹

The SEC also promulgated rules that have to be complied with by CRAs in order to manage conflicts of interest. Section 17 of the Code of Federal Regulations § 240.17g-5 and § 240.17g-6 prohibit certain acts and practices that could result in a conflict of interest. NRSROs, for example, are not allowed to issue or maintain ratings with respect to a person (excluding a sovereign nation or an agency of a sovereign nation) where the NRSROs, a credit analyst that participated in determining the rating or a person responsible for approving the credit, directly own securities of or have any other direct ownership interest in the rated entity. NRSROs are also not allowed to issue a rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the NRSRO who has responsibility for participating in determining ratings or for developing or approving procedures or methodologies used to determine credit ratings.¹⁰⁰

4. Reducing Regulatory Dependency on Ratings

Fourthly, several scholars suggest eliminating or limiting the use and reference to ratings issued by NRSROs in legislation. Regulators have to a certain extent “outsourced their safety judgments to third-

97. *Id.* at 25 (Annex I, § B(5)).

98. *Id.*

99. *Id.* at 25–26 (Annex I, § B(7)).

100. 12 C.F.R. § 240.17 (2013); *see also* Blumberg Cane et al., *supra* note 71, at 1096–02.

party CRAs.¹⁰¹ As a consequence, CRAs shifted from selling information to selling “regulatory licenses,”¹⁰² the “keys that unlock the financial markets.”¹⁰³ CRAs thus remain in business because financial legislation often requires a rating issued by an NRSRO as prerequisite for market access, for purchasing bonds by institutional investors or for other market activities, even if the rating later turns out to be incorrect.¹⁰⁴ The fact that CRAs offer services that became necessary for regulatory compliance is one of the reasons that created and sustained the “paradox of credit ratings.”¹⁰⁵ The paradox implies that although the informational value of ratings decreases (e.g. because investors increasingly allege that CRAs issued flawed credit ratings), CRAs, nonetheless, remain profitable and their ratings of major importance to regulate financial markets.¹⁰⁶

Both EU and U.S. regulators have tried to eliminate reference to the use of ratings in legislation or other documents. The Financial Stability Board¹⁰⁷ and the EU implemented measures to reduce overreliance on ratings. The EU pursues this objective by adopting a “multi-layer approach”¹⁰⁸ which implies, *inter alia*, that financial

101. Darbellay, *supra* note 4, at 40.

102. Partnoy, *supra* note 3, at 683.

103. Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, 25 J. INT’L. BANKING L. REV. 188, 189 (2010).

104. *Id.* at 190; LAWRENCE J. WHITE, FINANCIAL REGULATION AND THE CURRENT CRISIS: A GUIDE FOR THE ANTITRUST COMMUNITY 30–31 (2009); *see, e.g.*, BASEL COMMITTEE ON BANKING SUPERVISION, BASEL III: THE LIQUIDITY COVERAGE RATIO AND LIQUIDITY RISK MONITORING TOOLS 13–14 (2013) (stating that level 2A assets are limited to corporate debt securities (including commercial paper) and covered bonds that have a long-term credit rating from a recognized external credit assessment institution (ECAI) of at least AA-21 or in the absence of a long term rating, a short-term rating equivalent in quality to the long-term rating); *see also* BASEL COMMITTEE ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS 52–53 (2011).

105. Frank Partnoy, *The Paradox of Credit Ratings*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65 (Richard M. Levich, Giovanni Majoni & Carmen Reinhart eds. 2002).

106. *Id.* at 65–95; Partnoy, *supra* note 3, at 621–22; *Contra* Hill, *supra* note 7, at 66, n.114 (arguing that several factors show that the market influence of ratings is not only determined by their “favorable regulatory treatment” and using the example of issuers who sometimes purchase two ratings although regulations only require one, and that issuers often use ratings from the major and more expensive CRAs (for example, S&P and Fitch and Moody’s) and not from smaller CRAs, which might cost less).

107. *See* FINANCIAL STABILITY BOARD, PRINCIPLES FOR REDUCING RELIANCE ON CRA RATINGS (2010).

108. DIRECTORATE GEN. INTERNAL MKT. & SERVS. STAFF, EU RESPONSE TO THE FINANCIAL STABILITY BOARD: EU ACTION PLAN TO REDUCE RELIANCE ON CREDIT RATING

institutions are required to make their own credit risk assessment and not rely solely on credit ratings when assessing the creditworthiness of an entity or financial instrument.¹⁰⁹ The EU recommended that legislation and supranational institutions should refrain from referring to ratings in their guidelines, recommendations, and draft technical standards if it would cause authorities or other financial participants to rely solely or mechanistically on ratings.¹¹⁰

In the U.S., the Dodd–Frank Act deals with the removal of references to ratings in a similar manner. Section 939A directs each federal agency to review (1) any regulation it issued and which requires the use of an assessment of the creditworthiness of a security or money market instrument, and (2) any references to or requirement of reliance on ratings in such regulations. Each agency has to modify any such regulations to remove the reference to, or requirement of, reliance on ratings.¹¹¹

5. The Threat of Holding CRAs Liable

Finally, legislators in both the US and the EU have adopted provisions dealing with the liability of CRAs.¹¹² The European Union Commission Regulation on CRAs underlines the importance of ratings for investors and issuers. Ratings have a significant impact on investment decisions and on the image and financial attractiveness of issuers. As such, CRAs have an important responsibility to investors and issuers to ensure that they comply with the applicable requirements in the Regulation and that their ratings are independent, objective, and of adequate quality.¹¹³ At the same time, the Regulation acknowledges that it remains particularly difficult for investors to establish the liability of CRAs in the absence of a contractual relationship. The Regulation, therefore, establishes a right of redress for investors who have reasonably relied on a rating issued

AGENCY (CRA) RATINGS 4 (2014).

109. *Id.*

110. *Id.* at 5; *see also* Regulation 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation 1060/2009 on Credit Rating Agencies, art. 5, 2013 O.J. (L 146) 1, 13.

111. Dodd–Frank Act, Pub. L. 111–203, § 939A, 124 Stat. 1376, 1887 (2010).

112. *See generally* JAN DE BRUYNE & CEDRIC VANLEENHOVE, *Rating the EU Regulatory Framework on the Liability of Credit Rating Agencies: Triple A or Junk?*, 2 EDINBURGH STUDENT L. REV. 117, 117–28 (2015).

113. *See also Proposal for a Regulation of the European Parliament and of the Council Amending Regulation No. 1060/2009 on Credit Rating Agencies*, at 11, COM (2011) 747 final (Nov. 15, 2011) (§ 3.4.7).

in violation of Commission Regulation 1060/2009.¹¹⁴ Article 35a of Regulation 462/2013 addresses the liability of CRAs towards both issuers and investors.¹¹⁵ Investors bringing an action against CRAs under Article 35a must prove several elements, which are discussed in the following paragraphs.

Under Commission Regulation 1060/2009 as amended, CRAs are only liable when they commit any of the proscribed infringements intentionally or with gross negligence.¹¹⁶ CRAs will not face liability for simple negligence or for merely issuing an “incorrect” rating, nor does the Regulation impose liability on CRAs when they commit the infringement by mistake or because they did not use reasonable care.¹¹⁷ This standard of fault is appropriate as rating activities involve an assessment of complex economic factors and the use of different rating methodologies may lead to different results, none of which can actually be considered incorrect.¹¹⁸ Contrary to the proposed regulation,¹¹⁹ CRAs are able to limit their liability in advance where the limitation is reasonable and proportionate and allowed by the applicable national law.¹²⁰ Any limitation that does not comply with these requirements or any contractual exclusion of the liability is deprived of legal effect.¹²¹

The infringement of the Regulation must also have had an impact on the rating. The burden is on an investor to present accurate and detailed evidence that the CRA committed an infringement of the Regulation and that the infringement impacted the rating.¹²² Also contrary to the proposal, the Regulation does not contain a reversal of

114. Regulation 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, recital 32, 2009 O.J. (L 302) 1, 4.

115. *Id.* (art. 35).

116. *Id.*

117. *New rules on credit rating agencies (CRAs) enter into force—frequently asked questions*, EUROPEAN COMMISSION (June 18, 2013), http://Europa.EU/rapid/press-release_MEMO-13-571_en.htm.

118. Regulation 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation 1060/2009 on Credit Rating Agencies, recital 5, 2013 O.J. (L 146) 1, 8.

119. *Proposal for a Regulation of the European Parliament and of the Council Amending Regulation No. 1060/2009 on Credit Rating Agencies*, at 33, COM (2011) 747 final (Nov. 15, 2011) (stipulating that a CRA could not exclude or limit its civil liability in advance by an agreement on pain of being null and void).

120. Regulation 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation 1060/2009 on Credit Rating Agencies, 2013 O.J. (L 146) 1, 20.

121. *Id.*

122. *Id.* at 20–21.

the burden of proof for claims against CRAs.¹²³ The competent court must assess whether the presented information is accurate and detailed, taking into account the fact that the investor or issuer may not have access to the CRA's proprietary information.¹²⁴

The Regulation also requires a link between the infringement and the loss suffered by the investor in two ways. Firstly, the investor must establish that he reasonably relied on the rating in accordance with Article 5a, or otherwise.¹²⁵ While the Regulation does not define "reasonable reliance," it could imply that a CRA will not incur liability if the investors mentioned in the Regulation did not make their own credit risk assessment but relied solely on ratings to assess the creditworthiness of an entity or financial instrument.¹²⁶ Secondly, the investor must have reasonably relied on the rating for a decision to invest into, hold on to, or divest from a financial instrument covered by that rating.¹²⁷

If an investor shows (1) intentional or gross negligent infringement by the CRA; (2) actual impact of the infringement on the rating; (3) reasonable reliance on the rating; (4) for an investment decision, the investor may claim compensation from the CRA for its financial losses.¹²⁸ Several problems, however, remain with regard to the application of the Regulation. In addition to the high threshold of proof for third parties (e.g., reasonable reliance on the rating and the impact on decision making processes),¹²⁹ the Regulation refers to

123. *Proposal for a Regulation of the European Parliament and of the Council Amending Regulation No. 1060/2009 on Credit Rating Agencies*, at 33, COM (2011) 747 final (Nov. 15, 2011) (providing that if the investor established facts from which it could be inferred that a CRA committed an infringement, the burden of proof shifted to the CRA to demonstrate that it either did not commit the infringement or that the infringement did not have an impact on the issued rating).

124. Regulation 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation 1060/2009 on Credit Rating Agencies, 2013 O.J. (L 146) 1, 21.

125. *Id.* at 20–21.

126. *Id.* at 13.

127. *Id.* at 20–21.

128. *Id.*

129. See THOMAS M.J. MÖLLERS & CHARIS NIEDORF, *Regulation and Liability of Credit Rating Agencies—A More Efficient European Law?*, 11 EUROPEAN CO. FIN. L. REV. 333, 347–48 (2014). This paper discusses the requirement for investors to show that they exercised due care when using the rating in practice restricts liability claims to private investors, which was not initially intended by the legislature. A liability claim by those most likely to sue is practically prevented. As such, the liability regime in Article 35a remains a "theoretical claim." See also Jacob Kleinow, *Civil Liability of Credit Rating Companies: Quantitative Aspects of Damage Assessment from an Economic Viewpoint*, 11 INT'L & COMP. CORP. L. J. 134 (2015) (proposing a market price-oriented approach for the assessment of

national law for the interpretation and application of essential notions such as “damages,” “gross negligence,” “reasonably relied,” “due care,” and “impact.” Additionally, national law governs the liability of CRAs in areas such as causation and liability for ordinary negligence that the Regulation does not reach.¹³⁰

Several sections of the Dodd–Frank Act also contain provisions dealing with the liability of CRAs. Prior to the changes introduced by the Dodd–Frank Act, Rule 436(g) of the Securities Act stipulated that credit ratings from a NRSRO¹³¹ assigned to public offerings were not considered as an expert-certified part of the registration statement. Contrary to auditors, CRAs could not be held liable if the registration statement contained an incorrect rating.¹³²

The Dodd–Frank Act repealed Rule 436(g) of the Securities Act. As a consequence, the issuer has to seek the written consent of a NRSRO before including a rating in the registration statement. The NRSRO giving its consent can incur liability as an expert for the material misstatements or omissions concerning the credit rating that is included in the registration statement.¹³³ However, considering the threat of potential liability, NRSROs refused to give their consent. This led to the freezing and the collapse of the asset-backed securitization market because issuers were no longer able to offer

damage and urging regulators to develop a well-thought-out liability regime); Andreas Horsch, *Civil Liability of Credit Rating Companies—Qualitative Aspects of Damage Assessment from an Economic Viewpoint*, 11 INT’L & COMP. CORP. L. J. 107 (2015) (arguing that the liability regime in Article 35a is too inaccurate and insufficient regarding several aspects of damage assessment and that, as a consequence, the rule does not make sense from an economic perspective).

130. Commission Regulation 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation 1060/2009 on Credit Rating Agencies, art. 35a, sec. 4, 2013 O.J. (L 146) 1, 21.

131. Credit Rating Agency Reform Act of 2006, Pub. L. 109–291, § 3(a)(62), 120 Stat. 1327, 1328 (2006) (requiring a CRA applying for NRSRO status to be nationally recognized in the United States and provide credible ratings).

132. Dodd–Frank Act, Pub. L. 111–203, § 939G, 124 Stat. 1376, 1890 (2010); *see also In re Lehman Bros. Sec. & ERISA Litig.*, 681 F. Supp. 2d 495, 498–99 (S.D.N.Y. 2010) (affirming that CRAs do not fall within the definition of underwriter under § 11 of the Securities Act); *N.J. Carpenters Vacation Fund v. Royal Bank*, 720 F. Supp. 2d 254, 262–64 (S.D.N.Y. 2010); Allana M. Grinshteyn, *Horseshoes and Hand Grenades: The Dodd–Frank Act’s (Almost) Attack on Credit Rating Agencies*, 39 HOFSTRA L. REV. 956, 967–75 (2011); Schmid, *supra* note 35, at 1010–14.

133. Dodd–Frank Act, § 939G; *see also* Benjamin H. Brownlow, *Rating Agency Reform: Presenting the Registered Market for Asset-Backed Securities*, 15 N.C. BANKING INST. 111, 128 (2011) (discussing Dodd–Frank); Ellis, Fairchild & D’Souza, *supra* note 5, at 209–10.

securities.¹³⁴ The U.S. Committee on Financial Services, therefore, approved the removal of expert liability for CRAs (“no-action relief”) in July 2011.¹³⁵

Section 933(b) of the Dodd–Frank Act lessened the pleading requirements in private actions for securities fraud under Section 10(b) of the Securities and Exchange Act of 1934¹³⁶ and the related SEC Rule 10b-5.¹³⁷ Prior to the enactment of the Dodd–Frank Act, a plaintiff had to plead with particularity facts giving rise to a strong inference that CRAs misrepresented or failed to disclose material information with scienter.¹³⁸ Scienter has been defined as a “mental state embracing intent to deceive, manipulate or defraud.”¹³⁹ Following the changes introduced by Section 933(b), plaintiffs are only required to establish particular facts giving rise to a strong inference that a CRA knowingly or recklessly failed to (1) conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its methodology for evaluating the credit risk, or (2) obtain reasonable verification that such an investigation was done by a source independent from the issuer or underwriter.¹⁴⁰

134. Brownlow, *supra* note 133, at 131–33.

135. *Committee Acts to Eliminate Provision in Dodd–Frank That Shut Down Segment of Economy*, U.S. HOUSE OF REPRESENTATIVES FIN. SERVS. COMMITTEE (July 20, 2011), <http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=252949>.

136. Securities Exchange Act of 1934, Pub. L. 73–291, 48 Stat. 881 (1934).

137. Rule 10b-5, 17 C.F.R. § 240.10b-5 (2015); *see also* Eric C. Chaffee, *Standing Under Section 10(b) and Rule 10b-5: The Continued Validity of the Forced Seller Exception to the Purchaser–Seller Requirement*, 11 U. PA. J. BUS. L. 843 (2009).

138. 15 U.S.C. § 78u-4(b)(2)(A); *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13–14 (1971); Helwig v. Vencor, Inc., 251 F.3d 540, 554 (6th Cir. 2001); *In re IBM Sec. Litig.*, 163 F.3d 102, 106 (2d Cir. 1998) (confirming the requirement of scienter). *See, e.g., In re Moody’s Corp. Sec. Litig.*, 599 F. Supp. 2d 493, 514–16 (S.D.N.Y. 2009); *In re Nat’l Century Fin. Enter.*, 580 F. Supp. 2d 630, 637–38 (S.D. Ohio 2008) (establishing that in order to state a claim under Section 10(b) and Rule 10b-5(b), plaintiffs must allege in connection with the purchase or sale of securities: (1) a misstatement or omission, (2) of a material fact, (3) made with scienter, (4) justifiably relied on by plaintiffs, and (5) proximately causing them injury); *LaSalle Nat’l Bank v. Duff & Phelps Credit Rating Co.*, 951 F. Supp. 1071, 1082–83 (S.D.N.Y. 1996).

139. *Tellabs Inc. v. Makor Issues & Rights*, 551 U.S. 308, 319 (2007); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193–94 (1976); *see also* Allan Horwich, *An Inquiry into the Perception of Materiality as an Element of Scienter Under SEC Rule 10b-5*, 67 BUS. LAW. 1 (2011).

140. Dodd–Frank Act, §933; *see also* GREGORY A. FRENICOLA & JACOB GOLDSTEIN, CREDIT RATING AGENCIES, SKADDEN COMMENTARY ON THE DODD–FRANK ACT (2010); Brownlow, *supra* note 133, at 129–30; Ellis, Fairchild & D’Souza, *supra* note 5, at 209–10;

The threat of civil liability or actually holding CRAs liable increases the accuracy of credit ratings. The following parts, therefore, examine the reasons why regulators did the right thing to walk the liability lane to ensure that CRAs issue accurate ratings. At the same time, the article pleads for additional studies to thoroughly examine the modalities of the liability regime for CRAs (e.g. fault-based or strict liability).

III. THE WAY FORWARD—IMPOSING CIVIL LIABILITY UPON CRAS TO INCREASE THE ACCURACY OF CREDIT RATINGS

The previous paragraphs shed light on different proposals to reform the rating process. However, it is the threat of civil liability or actually holding CRAs liable that seems most able to guarantee that CRAs will issue accurate ratings. There are three reasons for this. Firstly, the traditional defenses invoked by CRAs against civil liability have gradually faded. As such, the way is paved for judges to hold CRAs liable for their wrongdoing.¹⁴¹ Secondly, several theoretical arguments also illustrate that civil liability triggers CRAs to issue accurate ratings.¹⁴² Finally, practical, legal-comparative as well as path-dependent arguments show that liability remains in pole position when it comes to ensuring the accuracy of ratings.¹⁴³

A. *Fading Away of Traditional Barriers Against Imposing Liability for CRAs*

Holding CRAs liable to investors has not always been straightforward in the past. CRAs have traditionally argued that they cannot be liable as their ratings are mere “opinions” and are, therefore, protected speech under the First Amendment of the US Constitution. They also rely on broad disclaimers accompanying their ratings to refute any liability.¹⁴⁴ In the past, CRAs were able to avoid

Eric S. Pendergraft, *Section 933(b): Nimble Private Regulation of the Capital Market Gatekeepers*, 39 FLA. ST. U. L. REV. 511, 511–31 (2012).

141. See *infra* Part III.A.

142. See *infra* Part III.B.

143. See *infra* Part III.C.

144. See, e.g., *In re Merrill Lynch Auction Rate Sec. Litig.*, 2011 WL 536437, 11 (S.D.N.Y. 2011); *Genesee Cty. Emp. Ret. Sys. v. Thornburg Mortg. Sec. Tr.*, 825 F. Supp. 2d 1082 (D.N.M. 2011); *Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.*, 651 F. Supp. 2d 155, 175–76 (S.D.N.Y. 2009); *In re Enron Corp. Sec. Derivative*, 511 F. Supp. 2d 742, 809–15 (S.D. Tex. 2005); *Cal. Pub. Emps.’ Ret. Sys. v. Moody’s Corp.*, 172 Cal. Rptr. 3d 238 (Cal. Ct. App. 2014); *Bathurst* [2012] FCA 1200 (Austl.).

liability by invoking these traditional defenses.¹⁴⁵ Moreover, plaintiffs often failed to establish the necessary elements to state a claim for negligence or negligent misrepresentation (e.g. a duty of care of the CRA toward investors or reasonable reliance on the rating)¹⁴⁶ or securities and common law fraud (e.g. scienter or knowledge of the falsity of the rating).¹⁴⁷ As if that were not enough, CRAs benefit from regulatory exemptions from liability in several jurisdictions.¹⁴⁸

The existence of such defenses, exemptions and a particularly high burden of proof sends the message to potential plaintiffs that filing claims against CRAs is in vain as they cannot be held liable anyway. Civil liability, therefore, might not increase the quality of ratings, as CRAs are able to hide behind these defenses. Put differently, without fear of liability, CRAs can “safely risk being less diligent and prudent than they otherwise would have been.”¹⁴⁹ For the same reasons, Ellis & Dow conclude that the threat of civil liability does not act as an adequate deterrent for misconduct. Rather, criminal liability for CRAs under the corporate ethos model can serve as an effective alternative.¹⁵⁰

However, things have changed following the 2008 financial crisis. The once-existing barriers to liability seem to have gradually disappeared and opened the door for judges to consider and impose liability. Recent decisions and especially those concerning ratings

145. See, e.g., *Compuware Corp. v. Moody's Inv'r Servs. Inc.*, 499 F.3d 520 (6th Cir. 2007); *Jefferson Cty. Sch. Dist. No. R-1 v. Moody's Inv'r Servs. Inc.*, 175 F.3d 848 (10th Cir. 1999).

146. See, e.g., *Quinn v. McGraw-Hill Co.*, 168 F.3d 331, 336 (7th Cir. 1999) (affirming that Quinn could not show that he reasonably relied on the rating because he was an “experienced” banker who should have done “his own homework”); *In re Enron Corp. Sec. Derivative*, 511 F. Supp. 2d 742, 826–27 (S.D. Tex. 2005) (holding that “there was no duty of care owed by the Credit Rating Agencies to CRRA regarding its loan to Enron, the Court grants the Rating Agencies’ motion to dismiss the negligent misrepresentation claim”).

147. See, e.g., *Plumbers’ Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 632 F.3d 762, 775–76 (1st Cir. 2011) (holding that the complaint did not expressly allege that S&P or Moody’s believed that the ratings were false or were unsupported by models that generally captured the quality of the securities being rated); *In re Nat’l Century Fin. Enter.*, 580 F. Supp. 2d 630, 634 (S.D. Ohio 2008) (concluding that the plaintiffs could not prove that the CRA acted with scienter “the complaint . . . can at best be read as showing that Moody’s was not rigorous in its review . . . of the NPF XII notes”); *Tolin v. Standard & Poor’s Fin. Servs.*, 950 F. Supp. 2d 714, 722–23 (S.D.N.Y. 2013) (concluding that the complaint did not allege adequately that S&P did not believe its ratings when the CRA made them).

148. CRAs are, for instance, excluded from prospectus liability in several countries.

149. Schmid, *supra* note 35, at 1009.

150. Ellis & Dow, *supra* note 55, at 207–12.

given to structured products, for instance, no longer blindly accept First Amendment protection for ratings. The First Amendment shield is not unconditional or unlimited for CRAs only because a rating is labeled “opinion.”¹⁵¹ Ratings of structured finance leading to the financial crisis will only be protected by the First Amendment if they are a matter of public concern and have been made available to the world and for the benefit of the general public (under the actual malice standard).¹⁵² Protection is also given if CRAs have not been involved in creating the securities that they subsequently rate and if they have not received rating fees “contingent upon the receipt of desired ratings [for such securities] and only in the event that the transaction closed with those ratings.”¹⁵³ In addition, case law shows

151. See, e.g., *Cal. Pub. Emps. Ret. Sys. v. Moody's Corp.*, 172 Cal. Rptr. 3d 238 (Cal. Ct. App. 2014).

152. See, e.g., *Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.*, 651 F. Supp. 2d 155, 175–76 (S.D.N.Y. 2009); *In re Enron Corp. Sec. Derivative*, 511 F. Supp. 2d 742, 820 (S.D. Tex. 2005); *Pan Am Corp. v. Delta Air Lines Inc. (In re Pan Am Corp.)*, 161 B.R. 577, 581–86 (S.D.N.Y. 1993); *Fed. Home Loan Bank of Pittsburgh v. J.P. Morgan Sec. LLC*, 19 Pa. D. & C. 16, 17 16–17 (Ct. Com. Pl. 2010); see also *Dun & Bradstreet Inc. v. Greenmoss Builders*, 472 U.S. 749, 762, 792 (1985) (holding that ratings are a matter of private concern and not protected by the actual malice standard if they are issued “solely in the individual interest of the speaker and its specific business audience”); *In re Nat'l Century Fin. Enter. Inc.*, 580 F. Supp. 2d 630, 639–40 (S.D. Ohio 2008); *LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co.*, 951 F. Supp. 1071, 1093–94, 1096–97 (S.D.N.Y. 1996); *Cal. Pub. Emps. Ret. Sys. v. Moody's Corp.*, 172 Cal. Rptr. 3d at 245 (“[T]he issuance of these SIV ratings is not, however, an issue of public concern. Rather, it is an economic activity designed for a limited target of making money.”); Caleb H. Deats, *Talk That Isn't Cheap: Does the First Amendment Protect Credit Rating Agencies' Faulty Methodologies from Regulation?*, 110 COLUM. L. REV. 1818, 1831–33 (2010); Lisbeth FREEMAN, *Who's Guarding the Gate? Credit-Rating Agency Liability as “Control Person” in the Subprime Credit Crisis*, 33 VT. L. REV. 585, 606–08 (2009); Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 39 CARDOZO L. REV. 1553, 1689–93 (2008); Partnoy, *supra* note 105, at 85–86; Jonathan W. Heggen, *Not Always the World's Shortest Editorial: Why Credit-Rating-Agency Speech is Sometimes Professional Speech*, 96 IOWA L. REV. 1745, 1754–58 (2011).

153. See *Am. Sav. Bank FSB v. UBS PaineWebber, Inc.*, 330 F.3d 104, 109–11 (2d Cir. 2003); *Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.*, 651 F. Supp. 2d 155, 167 (S.D.N.Y. 2009); *Commercial Fin. Servs., Inc. v. Arthur Andersen, LLP*, 94 P.3d 106, 108, 110–12 (Okla. Civ. App. 2004); see also Deats, *supra* note 152, 1836–37, 1850–63 (arguing that ratings should be qualified as commercial speech and as a consequence, they would receive less protection under the First Amendment); Freeman, *supra* note 152, at 606–09; David J. Grais & Kostas D. Katsiris, *Not “The World's Shortest Editorial”: Why the First Amendment Does Not Shield the Rating Agencies from Liability for Over-Rating CDOs*, BLOOMBERG L. REP., Nov. 2007, at 44 (arguing that First Amendment protection should not apply to CRAs in cases brought following the subprime-mortgage crisis); Parisa Haghshenas, *Obstacles to Credit Rating Agencies' First Amendment Defense in Light of Abu Dhabi*, 8 FIRST AMEND. L. REV. 452, 452–99 (2010); Heggen, *supra* note 152, at 1764–66; RACHEL JONES, *The Need for a Negligence Standard of Care for Credit Rating Agencies*, 1 WM. &

that CRAs are no longer able to always successfully rely on disclaimers accompanying their ratings to refute liability.¹⁵⁴

The fading away of the traditional defenses invoked by CRAs is one thing. Even more revolutionary in the rating legal landscape is the Australian *Bathurst* case which held S&P liable towards third-party investors. The court ruled that S&P had a duty to exercise reasonable care and skill in forming its opinion. CRAs must have reasonable grounds to issue the rating.¹⁵⁵ The court held that S&P owed a duty of reasonable care and skill towards “vulnerable” and “unsophisticated” investors with whom the CRA does not have a contract.¹⁵⁶ Investors are vulnerable if they are unable to assess the creditworthiness of the financial products or to “second-guess” the rating. This can occur if the rating is the only information available on the creditworthiness of the issuer of the securities.¹⁵⁷

The *Bathurst* judgment could have more effect on the diligence and reasonable care of CRAs than any of the discussed proposals in the second part of this article. This can be illustrated in several ways. Firstly, after the *Bathurst* decision, Bloomberg reported that McGraw-

MARY BUS. L. REV. 201, 213 (2010) (concluding that courts rely on four elements to determine the First Amendment protection given to ratings, namely whether CRAs “(1) rate debt which they are not paid to rate; (2) distribute the ratings through their publications; (3) have independence in gathering and evaluating information used for the rating; and (4) fulfill the general public function of providing information to the financial market”); A. Brooke Murphy, *Credit Rating Immunity? How the Hands-Off Approach Toward Credit Rating Agencies Led to the Subprime Credit Crisis and the Need for Greater Accountability*, 62 OKLA. L. REV. 735, 766–77 (2010).

154. See, e.g., *Abu Dhabi Commercial Bank*, 651 F. Supp. 2d at 175–78 (“For the same reasons, the disclaimers in the Information Memoranda that [a] credit rating represents a Rating Agency’s opinion regarding credit quality and is not a guarantee of performance or a recommendation to buy, sell or hold any securities, are unavailing and insufficient to protect the Rating Agencies from liability for promulgating misleading rating” (internal quotation omitted)); *King Cty. v. IKB Deutsche Industriebank AG*, 2012 WL 11896326, *49 (S.D.N.Y. 2012); *CalPERS v. Moody’s Corp.*, no. A134912, 28–29 (Cal. Ct. App. 2014), available at <https://www.courtlistener.com/opinion/2675786/calpers-v-moodys>; *Bathurst*, at 2524–25 (Austl.); *ABN AMRO Bank NV v. Bathurst Regional Council* [2014] FCAFC 65, para. 771 (Austl.) (rejecting the reliance of S&P on extensive disclaimers included in the rating reports to bar the plaintiff’s claims for recovery).

155. *Bathurst*, FCA 1200 (Austl.).

156. *Id.* at paras. 2767–78; *ABN AMRO Bank NV* [2014] FCAFC 65, paras. 580, 599, 890–891, 1211, 1263–1269; see also Harry Edwards, *Liability for the Rating and Sale of Structured Credit Products: Australian Cases and Their (much) Wider Implications*, 7 LAW & FIN. MKT. REV. 88, 90–91 (2013).

157. *Bathurst*, FCA 1200 (Austl.) at paras. 2767–78; *ABN AMRO Bank NV* [2014] FCAFC 65, at paras. 580, 599, 890–891, 1211 & 1263–1269; see also Edwards, *supra* note 156, at 90–91.

Hill and Moody's plummeted.¹⁵⁸ Future cases imposing liability upon CRAs might have similar consequences, which may make CRAs more diligent when issuing ratings. McKenna concludes in this regard that such a "market reaction is likely to alert ratings agencies of the costly effects of careless analysis."¹⁵⁹ Secondly, several commenters acknowledge that the *Bathurst* decision might not only have consequences for the conduct of CRAs but can also be a precedent for courts in other jurisdictions.¹⁶⁰ This can make CRAs aware that they are no longer bullet proof against liability depending on the jurisdiction in which they operate.¹⁶¹ This might lead to greater care when performing analyses and, therefore, increase the accuracy of their ratings. Finally, the *Bathurst* case might have more consequences on the drafting of rating contracts than the other, even quite innovative, proposals. In this regard, a rating agreement between a Belgian company and Moody's (on file with author) added an additional clause:

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158. David Fickling & Matthew Robinson, *McGraw-Hill Plummets After Australian Court Ruling*, BLOOMBERG, (Nov. 5, 2012, 2:01 PM), <http://www.bloomberg.com/news/articles/2012-11-04/s-p-found-liable-by-australian-court-for-misleading-ratings> ("S&P parent McGraw-Hill fell as much as 7.1 percent in New York, the most since August 2011, according to data compiled by Bloomberg. It dropped 4 percent to \$52.24. The parent of Moody's Investors Service declined as much as 4.4 percent, the most since November 2011, before closing down 3 percent at \$46.60.").

159. Lisa McKenna, *An Uncertain Forecast for Credit Rating Agencies: Liability for Negligent Misrepresentation after Bathurst*, COLUM. BUS. L. REV. ONLINE (NOV. 27, 2012, 7:50 AM) (2012), <http://cblr.columbia.edu/archives/12449>.

160. See, e.g., Harding & Donovan, *supra* footnote 6, at 194–95 ("[D]ue diligence undertaken to corroborate and verify the model used to produce a rating (including in relation to assumptions and stress testing) is likely to be increased in the wake of Bathurst, regardless of the ultimate outcome of any appeal . . . Bathurst stands as a poignant reminder that the information that underpins a rating of a financial product must be comprehensive and vetted critically before the rating is finalized and product marketing is distributed to potential investors."); see also Amanda Banton & Denee Theodorou, *Holding Ratings Agencies to Account—The Federal Court's Landmark Decision in Bathurst Regional Council v Local Government Financial Services*, LEXOLOGY.COM (Feb. 26, 2013), <http://www.lexology.com/library/detail.aspx?g=dc6a0ff8-ec3f-4ac5-893e-2758359ce477> ("The wider effect of Justice Jagot's decision in *Bathurst v LGFS* may ultimately be to create greater independence between ratings agencies and arranging banks, resulting in more reliable and truly independent ratings for investors.").

161. Jean Pierre Douglas-Henry, Samantha Kelly, Richard Hans & Matthew Saunders, *Australia: Ratings Agencies are No Longer Bullet Proof*, DLA PIPER PUBLICATIONS 1 (2012).

MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer It would be dangerous for "retail clients" to make any investment decision based on MOODY'S credit rating.

One can conclude that the inclusion of this clause in the contract explicitly referring to Australia and emphasizing once again that ratings are mere opinions is a direct result of the *Bathurst* case. As such, the decision concerning the liability of S&P in *Bathurst* is taken into account by CRAs when drafting rating agreements and thus indirectly influences their behavior.

B. Favoring Liability of CRAs from a Theoretical Perspective

There are also several theoretical reasons why liability increases the accuracy of ratings. Scholars argued that if CRAs are considered gatekeepers,¹⁶² the threat of civil liability can be used to deter wrongdoing.¹⁶³ That is because the primary objective of tort liability is the deterrence of unreasonable risks.¹⁶⁴ Whereas some favor a negligence-based liability regime for CRAs,¹⁶⁵ others have proposed a modified strict liability for gatekeepers including CRAs.¹⁶⁶ Although

162. See JOHN C. COFFEE, *GATEKEEPERS: THE ROLE OF THE PROFESSIONS IN CORPORATE GOVERNANCE* 283–317 (1st ed. 2006); F. PARTNOY, *supra* note 105, at 59–102.

163. See Dennis, *supra* note 76, at 1140–41; Ellis, Fairchild, D'Souza, *supra* note 5, at 182. See generally SYLVIA A. LAW & STEVEN POLAN, *PAIN AND PROFIT: THE POLITICS OF MALPRACTICE* (1st ed. 1978); RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* (7th ed. 2007).

164. See David Rosenberg, *The Judicial Posner on Negligence Versus Strict Liability: Indiana Harbor Belt Railroad Co. v. Am. Cyanamid Co.*, 120 HARV. L. REV. 1210, 1212 (2007); see also Alan D. Miller & Ronen Perry, *The Reasonable Person*, 82 N.Y.U. L. REV. 323, 328 (2012) ("[A]ccording to economic wisdom, this deterrence of unreasonable risk is the primary objective of tort liability"); Gary T. Schwartz, *Reality and the Economic Analysis of Tort Law: Does Tort Law Really Deter?*, 42 UCLA L. REV. 377, 377 (1994) (concluding that tort law, while not as effective as economic models might suggest, in its moderate form (that is sector-by-sector) may still be successful in achieving its stated deterrence goals).

165. See, e.g., Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 951–58 (1998) (advocating a self-tailored liability regime for gatekeepers under which they may specify the type of due diligence procedures to which they will adhere).

166. See, e.g., John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms* (Columbia Law & Economics Working Paper No. 237, 2003)

the grounds of liability (e.g. whether CRAs should face strict or fault-based liability) and several other modalities (e.g. toward which third parties they can be held liable) should be thoroughly analyzed in another study, it suffices for now to note that imposing civil liability upon CRAs might increase the quality of ratings from a theoretical point of view.¹⁶⁷ The following paragraphs will set forth several arguments that either find their roots in a strict- or negligence-based regime to underpin the conclusion that the threat of civil liability increases the accuracy of ratings.

By way of a preliminary consideration, Jones notes that the rating market needs to have some form of incentive to ensure that CRAs issue accurate ratings. The threat of holding CRAs liable in tort (e.g. for negligence or negligent misrepresentation) can provide such an incentive.¹⁶⁸ However, imposing liability on CRAs seems useful only if two assumptions are met. Firstly, the market is unable to make CRAs invest in the accuracy of ratings on its own.¹⁶⁹ This arguably is the case as reputational constraints alone have not always prevented CRAs from issuing flawed ratings.¹⁷⁰ In addition, many of the

(proposing a modified form of strict liability for gatekeepers where gatekeepers would act as insurers of their own certification but with an insurance policy capped at a realistic level, being an adequate multiple of the highest annual revenues they recently received from their (wrongdoing) client over the last several years); *see also* Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 102–08 (2003) (suggesting the choice of strict versus fault or knowledge-based liability according to how equipped enforcement authorities are to enforce violations by gatekeepers); Trotter Hardy, *The Proper Legal Regime for Cyberspace*, 55 U. PITT. L. REV. 993, 1044–46 (1994) (advocating strict liability on internet system administrators); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 491 (2001); Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 365 (2004).

167. *See* Blumberg Cane, *supra* note 71, at 1102–24; Dennis, *supra* note 76, at 1148–50; Jones, *supra* note 153, at 226–31; Ellis, Fairchild & D’Souza, *supra* note 5, at 217–21; Haar, *supra* note 8, at 315–34; Steven Harper, *Credit Rating Agencies Deserve Credit for the 2007–2008 Financial Crisis: An Analysis of CRA Liability Following the Enactment of the Dodd–Frank Act*, 68 WASH. & LEE L. REV. 1925, 1957–72 (2011); Alessio M. Paccès & Alessandro Romano, *A Strict Liability Regime for Rating Agencies*, (European Corporate Governance Institute Law Working Paper No. 245, 2014); Alessandro Scarso, *The Liability of Credit Rating Agencies in a Comparative Perspective*, 4 J. EUR. TORT L. 162 (2013); Partnoy, *supra* note 105, at 95–96.

168. Jones, *supra* note 153, at 226.

169. *See* Frank Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 678 (1984); Gregory Husisian, *What Standard of Care Should Govern the World’s Shortest Editorials? An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 440 (1990) (referring to RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 513–14 (3d ed. 1986)).

170. Dennis, *supra* note 76, at 1115, 1131–40 (referencing several studies); Partnoy, *supra* note 3, at 619–12 (challenging the reputational capital view); *see also supra* Parts II.B

discussed innovative proposals to manage conflicts of interest and increase the accuracy of ratings have so far not been adopted by supra- and national legislators. As such, there is currently no alternative available on the market to regulate the conduct of CRAs. More striking is that the practice under which CRAs design securities to ensure that they qualify for the highest rating (which in turn might influence the amount of the rating fee) did not make CRAs invest in accuracy. CRAs are under such circumstances only motivated to give high ratings in order to increase their revenues from the issuer.¹⁷¹

Secondly, liability is only appropriate to the extent that the judicial system is able to identify a CRA's negligent conduct without the risk of "falsely implicating non-negligent behavior."¹⁷² In essence, CRAs will not be liable if courts are unable to determine when a credit rating is inaccurate or when the CRA acted negligently. Adopting a negligence-based standard might increase claims against CRAs but not enhance the welfare of investors or encourage CRAs to attain a higher level of care if courts are unable to actually hold CRAs liable. Considering that the rating process is complex and specialized, courts might not have the proper and required expertise and would "have great difficulty distinguishing significant factors from insignificant ones."¹⁷³ In addition, holding CRAs liable might require "substantial" oversight by the government, especially in developing performance standards, which again leads to additional costs.¹⁷⁴ In sum, even though investors might file suits against CRAs for their alleged misconduct, legal proceedings will in most cases be fruitless for investors.¹⁷⁵

However, things are once again different in the post-financial-crisis climate. The *Bathurst* decision, for instance, illustrated that courts have the technical capacity to determine whether a CRA acted reasonably, even when it concerns ratings given to complex securities. Courts are not afraid to hold CRAs liable if they did not act reasonably and lacked reasonable grounds to issue the rating.¹⁷⁶

and II.C (referencing academic studies).

171. See cases discussed *supra* notes 6–7; see also cases discussed *infra* Part III.C.

172. Husisian, *supra* note 169, at 440.

173. *Id.* at 440, 443–44.

174. Gudzowski, *supra* note 18, at 279.

175. JOSHUA D. KREBS, *The Rating Agencies: Where We Have Been and Where Do We Go From Here*, 3 J. BUS. ENTREPRENEURSHIP & L. 134, 158 (2009).

176. *Bathurst* [2012] FCR 120 (Austl.); *ABN AMRO Bank NV v Bathurst Reg'l Council* [2014] FCAFC 65 (Austl.).

Moreover, as previously discussed, CRAs are no longer able to hide behind the traditional defenses. This paves the way for judges to actually assess whether CRAs are liable. The concern of the government's promulgation of performance standards also needs to be seen in a nuanced light. That is because extensive standards and regulations have already been adopted by the SEC, the EU and especially the IOSCO.¹⁷⁷ In addition, one can also think to establish some formal and periodic assessment of how accurate the CRAs were in calculating ratings, in other words somebody who rates the CRAs themselves.¹⁷⁸

The threat of liability is an effective way to make sure that CRAs issue accurate ratings. The analysis in the following paragraphs is based on the findings of Husisian. Husisian extensively relies on works by Posner¹⁷⁹ and Calabresi,¹⁸⁰ and gives three general reasons why imposing liability upon CRAs for negligence might increase the accuracy of their ratings: the "least-cost avoider" argument,¹⁸¹ the "optimum level of care" argument,¹⁸² and the "risk-spreading" argument.¹⁸³ Although he eventually concludes that expanding CRAs' liability for negligence remains problematic from an economic point of view, the arguments underpinning this conclusion no longer seem convincing in the current post-financial-crisis era. In essence, I re-evaluate the arguments of Husisian to conclude that the threat of holding CRAs liable triggers them to issue accurate ratings. Imposing liability, for instance, would increase the CRAs' variable cost and make them cut back on rating those securities that pose the greatest

177. See TECHNICAL COMMITTEE OF THE INT'L ORG. OF SEC. COMMISSIONS, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES (2004) (updating the Code after the 2008 financial crisis to cover the rating of structured finance products and related transactions); see also TECHNICAL COMMITTEE OF THE INT'L ORG. OF SEC. COMMISSIONS, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES 2008 (where CRAs are expected to give full effect to the Code of Conduct as investors might see compliance with it as a sign of good governance); Graeme Baber, *The Role and Responsibility of Credit Rating Agencies in Promoting Soundness and Integrity*, 17 J. MONEY LAUNDERING CONTROL 34, 34–49 (2014); Uwe Blaurock, *Control and Responsibility of Credit Rating Agencies*, 11 ELECTRONIC J. COMPARATIVE L. 1, 26–27 (2007); DARBELLAY, *supra* note 4, at 64 (IOSCO initiatives in the field of CRAs are discussed in-depth).

178. Blumberg Cane, *supra* note 71, at 1126.

179. RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 666 (2d ed. 1986).

180. GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 340 (1st ed. 1970).

181. See *infra* Part III.B.1.

182. See *infra* Part III.B.2.

183. See *infra* Part III.B.3.

risk. Some argue that the securities with the biggest risk are those issued by new and young firms. However, the financial crisis showed that this is not per se the case.¹⁸⁴ Similarly, the argument that holding CRAs liable might open the floodgates and even lead to their collapse needs to be taken with a grain of salt.¹⁸⁵

1. The Least-Cost Avoider Argument

This rationale implies that the tort system should impose liability on the least-cost avoider of mistakes. The system encourages the party that can most easily avoid the harm (e.g. financial losses) by incurring the least expenses to take steps to avoid mistakes such as investment in a product that later defaults. In the rating business, the CRA is probably the least-cost avoider, not only because of its expertise and potential access to the issuer's confidential information, but also because it would cost the investor much more to "play[] detective" and investigate the issuer's creditworthiness.¹⁸⁶ Courts grounding their decision on the least-cost avoider argument would, therefore, be inclined to impose liability on CRAs as they are able to avoid potential mistakes more cheaply than investors.¹⁸⁷

Some question whether CRAs actually are the least-cost avoiders of mistakes. Husisian, for instance, concludes that in reality CRAs will have to show that they did not act negligently if the plaintiff proves a prima facie case.¹⁸⁸ To meet this burden of proof, CRAs will have to document their actions, report the reasons why a particular rating was given and "always conduct [their] business with an eye toward how their actions would look to a judge and jury."¹⁸⁹ Liability for CRAs will lead to increased costs in terms of monitoring and recordkeeping requirements. These costs will probably be passed on to the issuers, resulting in higher credit-rating fees.¹⁹⁰ The problem, however, is that recordkeeping requirements do not necessarily result in better ratings but only show that CRAs already produced non-

184. See *infra* Part III.B.4.

185. See *infra* Part III.B.5.

186. Husisian, *supra* note 169, at 431.

187. *Id.* at 430–31.

188. See *Prima facie*, BLACK'S LAW DICTIONARY (6th ed. 1990) (a fact presumed to be true unless disproved by some evidence to the contrary).

189. Husisian, *supra* note 169, at 434 (citing Daniel R. Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 BROOK. L. REV. 1051 (1986)).

190. See Caitlin M. Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What Can be Done to Protect Investors*, 50 B.C. L. REV. 1275, 1296–97 (2009).

negligent products. The costs associated with maintaining the documents and records are wasted from a societal point of view, as they have not been invested in making more accurate or better ratings.¹⁹¹ As such, the imposition of liability would be nothing more than a waste of resources because it does not increase the social welfare but only redistributes resources from the CRA to the investor.¹⁹² Moreover, Hill argues that CRAs will make sure not to leave any records showing that the underlying documentation is unreasonable if fault-based liability were to be imposed. CRAs could avoid fault-based liability simply by adopting and adhering to appropriate procedures. These procedures, however, do not prevent CRAs from relying on false assumptions to underpin rating models that contributed to the flawed ratings of mortgage-backed securities that led to the financial crisis.¹⁹³ CRAs might also need more time and efforts to rate new and complex instruments if they face the risk of being held liable for inaccurate ratings. As a consequence, CRAs will spend more time preparing the rating, which could delay companies in issuing securities that require a rating.¹⁹⁴ This could potentially lead to a stand-still or freezing of the asset-backed securities market.¹⁹⁵

As rightly pointed out by Ellis, Fairchild, and D'Souza, even if the concerns in the previous paragraph are true, encouraging CRAs to spend more time and care when issuing ratings is a "laudable goal."¹⁹⁶ There is evidence, not in the least illustrated by *Bathurst* and other pending cases,¹⁹⁷ that in the time leading up to the financial crisis, CRAs did not spend the appropriate amount of time and care evaluating the securities that they rated.¹⁹⁸ In addition, there are two other reasons why the previously mentioned arguments against the least-cost avoider rationale seem less convincing.

Firstly, it remains unlikely that additional recordkeeping

191. Husisian, *supra* note 169, at 434.

192. Gerhard Wagner, Gatekeeper Liability: A Response to the Financial Crisis 16–19 (Aug. 2013) (paper presented at the Law and Economics Workshop of Tel Aviv University), <http://ssrn.com/abstract=2317213>.

193. Hill, *supra* note 11, at 605.

194. Brownlow, *supra* note 133, at 133.

195. See also *supra* Part II.E.5 (discussing the problems that occurred with the introduction of prospectus liability for CRAs in the United States and the consequences it had on the securities market).

196. Ellis, Fairchild & D'Souza, *supra* note 5, at 216.

197. See *supra* discussion at 6–7; *infra* Part III.B.5.

198. Ellis, Fairchild & D'Souza, *supra* note 5, at 216–17.

obligations, aimed at providing proof that CRAs acted with reasonable care, will increase the costs for CRAs. CRAs must already extensively document their actions and disclose information on their credit rating methodologies under both EU¹⁹⁹ and U.S. law.²⁰⁰ As such, the argument that liability will only increase costs in terms of monitoring and recordkeeping requirements, ultimately increasing the rating fees without actually producing “better” credit ratings, falls flat. CRAs are already required to comply with strict recordkeeping requirements under EU and U.S. law. The threat of liability will not suddenly change or impose additional requirements and costs for CRAs.²⁰¹

Secondly, Wagner concludes that the distinction between private

199. *E.g.*, Commission Regulation 1060/2009 on Credit Rating Agencies, 2013 O.J. (L 146) 1, 25. Annex I, Section B of the EU Regulation on CRAs, (stipulates that CRAs have to arrange for adequate records and, where appropriate, keep audit trails of their rating activities). Those records have to include (1) files documenting the procedures and methodologies used by the CRA to determine the rating, (2) the internal records and files used to form the basis of any rating decision taken, (3) records of the procedures and measures implemented by the CRA to comply with the EU Regulation and (4) copies of internal and external communications, including electronic communications, received and sent by the CRA and its employees that relate to the rating activities. The Regulation contains additional requirements for CRAs in relation to ratings given to structured finance instruments. For instance, CRAs have to state the level of assessment they have performed with regard to the due diligence processes carried out at the level of underlying financial instruments or other assets of structured finance instruments. The disclosure of rating methodologies, models and key rating assumptions has to be accompanied with guidance which explains the assumptions, parameters, limits and uncertainties surrounding the models and rating methodologies used in ratings of structured finance. Such guidance needs to be clear and easily comprehensible. Section D of Annex I requires CRAs to disclose information about all structured finance products submitted for their initial review or for a preliminary rating on an ongoing basis. Finally, Section E of Annex I contains general methodologies and a description of the models and key rating assumptions such as mathematical or correlation assumptions and periodical disclosure requirements, for example, of data about the historical default rates of rating categories for CRAs.

200. *E.g.*, Credit Rating Agency Reform Act of 2006, Pub. L. 109–291, § 15E, 120 Stat. 1327, 1329–1330 (2006) (codified at 15 U.S.C. § 78o–7); Dodd–Frank Act, Pub. L. 111–203, § 932(a)(3), 124 Stat. 1376, 1873 (2010). The Credit Rating Agency Reform Act and the Dodd–Frank Act also contain disclosure and recordkeeping obligations for CRAs operating in the US. For instance, an application for registration requires the CRA to submit (1) credit ratings performance measurement statistics over short-term, mid-term and long-term periods and (2) procedures and methodologies that the applicant uses in determining credit ratings. Pursuant to Section 932(a)(3) of the Dodd–Frank Act, NRSROs have to establish and document an effective internal control structure which governs the implementation of and adherence to policies, procedures and methodologies for determining ratings. More importantly, 17 C.F.R. § 240.17g-2 stipulates all the records that NRSROs have to make and retain, for example, a record documenting the procedures and methodologies used by the CRAs to determine credit ratings.

201. *See also* Ellis, Fairchild & D’Souza, *supra* note 5, at 219.

and social losses misses an essential point because holding CRAs liable would make a difference in terms of “allocative efficiency.”²⁰² More specifically, if ratings are reliable, investors will not have to bear the costs of doing their own investigation or buying information from other sources. On the other hand, if ratings are unreliable, investors will incur costs as they will have to protect themselves from losses that can incur in capital markets. Each investor would have to collect and analyze public information, seek advice from other experts, or perform an own analysis before purchasing financial products. The private and social costs associated with such activities are substantial compared to a situation in which only one expert institution, the CRA, would issue reliable ratings that can be used by all investors. Moreover, flawed ratings can lead to a misallocation of resources throughout the general economy. Take the example of mortgage-backed securities. Investors would not have purchased those securities if CRAs had been subject to stricter standards of care when calculating the ratings. Money would have stopped flowing into those products much earlier resulting in a different allocation of capital. In sum, the social losses caused by inadequate ratings, although smaller than the private losses, are “greater than zero.”²⁰³

2. The Optimum Level of Care Argument

The optimum level of care is another argument relied upon to advocate liability for CRAs. In an ideal world of perfect information, investors might contract with another CRA or pay less rating fees when discovering that the initial rating of the hired CRA is inaccurate. Consequently, the hired CRA would have to reduce the price of its products to reflect the below-optimum investment in accuracy. In sum, the CRA will have to increase its investment in accuracy in order to avoid lowering the price or losing market share to other CRAs that offer more accurate ratings.²⁰⁴

Taking into account the information costs,²⁰⁵ CRAs will, however, invest in the accuracy of their credit ratings only until the marginal cost of doing so equals the increase in marginal revenue achieved by displaying greater accuracy. CRAs are aware that they

202. Wagner, *supra* note 192, at 19.

203. *Id.* at 20.

204. Husisian, *supra* note 169, at 430–32.

205. See Partnoy, *supra* note 166, at 503–04 n.30 (explaining that information costs are the costs that result from a due diligence assessment).

can make some errors through underinvestment in accuracy, which the market will never discover. The investment in accuracy of ratings can also lead to a marginal change in revenue that is less than the benefits of not investing in an optimal level of accuracy. As such, underinvesting in the accuracy of ratings sometimes becomes a rational profit-maximizing strategy for CRAs. The threat of liability for not sufficiently investing in accuracy might, therefore, increase the standard of care that CRAs will use. A credit rating agency would have to consider whether it is exposing itself to potential liability for any degree of negligence by its failure to invest in the accuracy of ratings. Imposing the costs of underinvesting in the accuracy of ratings on CRAs might create an incentive to not act negligently.²⁰⁶

3. The Risk-Spreading Argument

Another argument for why CRAs should face liability is related to the spreading of risk. CRAs will internalize potential costs in the rating fee if courts threaten to hold them liable for their negligent conduct. CRAs will charge higher prices for their services and pass these costs on to the issuer of securities or subscribers paying for the rating services. CRAs can pass the costs on to the extent that the issuers and paying subscribers are willing to bear the increased costs of the rating. As a consequence, CRAs that are more negligent than their competitors will have higher costs to pass on. This might alarm issuers and subscribers that such CRAs are not issuing accurate ratings. Underinvesting CRAs, therefore, will be forced to invest in the accuracy of their ratings or suffer the pain of losing business to other CRAs that provide more accurate services.²⁰⁷

Furthermore, CRAs derive most of their income from rating fees. In order to cover the potential costs of liability, CRAs will have an incentive to charge higher prices to clients who misrepresent their financial position or provide poor information. They will pass on the costs of potential liability to those firms that gave inaccurate information in the past or appear to hide important information. As a result, issuers are encouraged to provide the most accurate financial information possible on which the rating will subsequently be based. If issuers fail to provide accurate data, the cost of raising capital or issuing securities raises because of the higher rating fees. In essence, the threat to hold CRAs liable will trigger the least-cost providers of

206. Husisian, *supra* note 169, at 431–32.

207. *Id.* at 432–34.

the information, namely the rated companies themselves, to give information of sufficient quality, which in turn might lead to more accurate ratings.²⁰⁸

At the same time, however, Husisian notes that the problem of cross-subsidization might occur when CRAs face potential liability in tort. It has already been mentioned that CRAs, besides rating fees, can also charge subscription fees to investors. The CRA will downstream the potential costs of tort liability (e.g. the costs related to insurance coverage) to all its subscribers equally. That is because CRAs charge a fixed price for each subscription, as it remains difficult to price discriminate between large and small investors. As a consequence, the small subscribers will “cross-subsidize”²⁰⁹ the large subscribers. The cost of subscription for small investors will rise by more than the expected value of future suits they might bring against CRAs. The cost for large investors, on the other hand, rises by less than the expected value of the lawsuits they might initiate against CRAs. Each investor pays the same amount for the CRA’s insurance costs, but larger investors are more likely to “cash in the policy in the courtroom.”²¹⁰ As a result, the number of small subscribing investors might decrease, whereas the number of large subscribing investors will increase. This ultimately leads to the result that those investors who most value ratings are not able to use them anymore. Imposing a negligence standard would also lead to underinvestment in the market by smaller investors. After all, smaller investors are the market participants who in most cases do not have access to services competing with CRAs such as in-house technical analysts. This is problematic as the threat of liability for negligent conduct should increase the level of investment based on good information rather than decreasing it.²¹¹

Once again, this argument needs to be taken with a grain of salt. More specifically, the underlying reasons for the risk-spreading argument are based on the idea that the CRAs’ major income revenue stems from the fees paid by subscribers. However, research showed that approximately ninety percent of the revenues of CRAs stems from issuers paying for the ratings and not from the subscription

208. *Id.* at 433–34.

209. *Id.* at 435.

210. *Id.* at 436.

211. *Id.* at 435–37.

fees.²¹² Moreover, although CRAs still “make some money from subscriber fees,”²¹³ much of the information provided by CRAs is freely available for the public through registration on the websites of CRAs.

4. Rating (Risky) Securities of New & Young Firms

The financial crisis also showed that some other arguments against keeping CRAs immune from liability are no longer valid. It has, for, instance, been argued that liability would increase the CRA’s variable cost. CRAs decide whether to publish a rating based on the expected profits or losses of doing so. A higher chance of liability for CRAs increases the variable costs of publishing a rating. That is because there is a chance that courts will find the CRA liable for a negligent mistake with regard to every rating it issues. In reaction to this growth of variable costs, the CRA might cut back on those ratings that increase its marginal variable costs the most. The bonds and securities issued by small and new firms are the most expensive to rate. As a consequence, CRAs will not be inclined to rate companies that pose the greatest threat of liability, namely new or small firms that actually most benefit from independent ratings.²¹⁴

Besides the lack of data underpinning this argument, the financial crisis showed that not the “young or small or unstructured”²¹⁵ companies posed the greatest risk. Rather, the financial incentives and unreasonable conduct of CRAs themselves contributed to the collapse of the financial markets. The unreasonable and profit-oriented behavior of CRAs, and not the position or size of issuers, was the primary reason why CRAs have been held liable so far. This follows from the cases in which investors have targeted CRAs for the flawed ratings given to structured asset-backed securities.²¹⁶ In this regard, both the extent to which CRAs were involved in structuring the issuer’s financial instruments as well as the remuneration structure play a key role in determining the First

212. Lynch, *supra* note 22, at 239–40; Partnoy, *supra* note 105, at 69.

213. Claire Hill, *Rating Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV. 1145, 1147–48 n.20 (2003).

214. Husisian, *supra* note 169, at 437–39.

215. John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1967 (1988); *see also* Coffee, *supra* note 7, at 252 (arguing that the threat of liability could lead the CRAs to stop rating “risky structured finance products”).

216. *See supra* footnotes 6–7 (overviewing cases); *see also* discussion *infra* Part III.B.5.

Amendment protection given to ratings. The *Abu Dhabi* court, for example, acknowledges the relationship between the existence of conflicts of interest and their impact on the dissemination of false ratings on the one hand and the First Amendment protection on the other hand. The CRAs did not only rate such complex securities but also advised issuers on how to structure and design them to qualify for the highest rating. At the same time, they received rating fees which were “contingent upon the receipt of desired ratings [for such securities] and only in the event that the transaction closed with those ratings.”²¹⁷ As such, CRAs knew “that the ratings process was flawed[,] . . . that the portfolio was not a safe, stable investment, and . . . that [they] could not issue an objective rating because of the effect it would have on their compensation.”²¹⁸

Similarly, the court in the Australian *Bathurst* case concluded that S&P violated its duty of care because the CRA did not have reasonable grounds to assign the rating. The rating was not the result of reasonable care and skill.²¹⁹ S&P did not develop its own model for rating constant proportion debt obligation (CPDOs), but instead relied on the model created by ABN Amro. The CRA did also not give any consideration to the model risk when assigning the credit rating.²²⁰ S&P adopted a 15% volatility figure that had been provided to it by ABN Amro. There was no evidence that S&P checked the 15% volatility figure itself. However, S&P could have easily calculated the volatility and would then have realized that the correct figure was around 28%. A reasonable and prudent CRA would have done its own calculations and surely not have adopted a volatility figure of 15%.²²¹

217. *Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.*, 651 F. Supp. 2d 155, 167 (S.D.N.Y. 2009).

218. *Id.* at 178–79; *see also* *Fed. Home Loan Bank of Boston v. Ally Fin.*, No. 11–10952–GAO, 2013 WL 5466628, at *2 (D. Mass. Sept. 30, 2013) (“[Plaintiff has] “pled with sufficient particularity that the Rating Agency Defendants issued ratings that they did not genuinely or reasonably believe. For example, the Amended Complaint alleges that the Rating Agency Defendants diluted their own standards and carried out their ratings procedures in an intentionally lax manner as to [private label mortgage-backed securities] while maintaining higher standards in other contexts. The Bank has also sufficiently pled scienter, alleging that the Rating Agency Defendants competed for business by artificially inflating ratings, as they were only paid if they provided high ratings.”); *see also infra* Part III.B.5 for a discussion of case law.

219. *Bathurst*, FCA 1200 (Austl.) at paras. 2814–36; *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65, at paras. 12, 503 & 722; *see also* *Banton & Theodorou*, *supra* note 160, at 5; *Harding & Donovan*, *supra* note 6, at 192.

220. *Bathurst*, at paras. 2547, 2555–90.

221. *Bathurst*, at paras. 2611–69; *see also* *Banton & Theodorou*, *supra* note 160, at 5;

The court held that the analysis of S&P did not comprise mere mistakes or errors of judgment. Rather, it “involve[s] failures of such a character that no reasonable ratings agency exercising reasonable care and skill could have committed in the rating of the CPDOs.” In sum, the “[rating] analysis was fundamentally flawed, unreasonable and irrational in numerous respects.”²²²

5. Does Liability of CRAs Really Open the Floodgates?

The concern also arose that, even if liability for CRAs has the effect of deterring “bad” behaviors, it might result in frivolous lawsuits and open the floodgates against CRAs. This would have dramatic consequences for the rating business.²²³ However, the threat of liability does not necessarily mean that CRAs will automatically be held liable once courts are confronted with claims. That is because plaintiffs often have to prove several elements for liability claims against CRAs to be successful.²²⁴

From a Belgian perspective, for instance, in the absence of specific legislation on the liability of CRAs, investors have to ground their claims on the Articles 1382-1383 of the Belgian Civil Code (BCC) to recover in tort from the CRA. Pursuant to the Articles 1382-1383 BCC, an investor will have to prove that the CRA committed a wrongful act, that he incurred damages, and that there is a causal link between both elements.²²⁵ As such, courts will not automatically hold CRAs liable only because they have already incurred liability in the past. Reference can in this regard be made to Belgian case law dealing with the third-party liability of the auditor. The investor still has to prove in each case that he incurred financial losses and that there was a causal link with the issuance of the wrong audit opinion, even when courts already held the auditor liable towards third parties at several occasions in the past.²²⁶

Harding & Donovan, *supra* footnote 6, at 192.

222. *Bathurst*, at paragraph 2836; *ABN AMRO Bank NV*, FCAFC 65 at paras. 12, 566–722; *Banton & Theodorou*, *supra* note 160, at 5; *Harding & Donovan*, *supra* footnote 5, at 192.

223. *Hill*, *supra* note 7, at 89; *Horner*, *supra* note 37, at 504; *Mulligan*, *supra* note 190, at 1297; *Arthur Pinto*, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMPARATIVE L. 341, 355 (2006).

224. *Ellis, Fairchild & D’Souza*, *supra* note 5, at 217.

225. HUBERT BOCKEN, INGRID BOONE & MARC KRUIHOF, HET BUITENCONTRACTUEEL AANSPRAKELIJKHEIDS-RECHT EN ANDERE SCHADEVERG OEDINGSMECHANISMEN [OUTSIDE THE CONTRACTUAL LIABILITY: LAW AND OTHER COMPENSATION MECHANISMS] 46–203 (3d ed. 2014).

226. See INGRID DE POORTER, CONTROLE VAN FINANCIËLE VERSLAGGEVING:

Another case which shows that the mere possibility of holding certifiers liable will not open the floodgates is the *Vie d' Or* decision, in which the Dutch Supreme Court clearly set the boundaries of the third-party liability of the auditor. The *Hoge Raad* (Supreme Court of the Netherlands) held that accountants have a duty of care towards third parties when performing tasks that have a wider public importance such as the certification and control of annual accounts (the so-called public role of the auditor). To determine if auditors can be held liable towards a specific third party, the judge needs to examine how a reasonable and competent accountant who carefully performs his duties and takes into account the third party's interests, would have acted. Whether the accountant violated his duty of care has to be established by taking into account all circumstances of the case.

The *Hoge Raad* subsequently enumerated a checklist to decide if the accountant violated his duty of care. Factors that have to be taken into account are (1) the extent to which the requirements concerning financial audit reporting incorporated in EU and national legislation have been respected; (2) the nature of the violated norm; (3) the seriousness of the violation; (4) the measures taken or information given by the accountant to limit the financial loss; (4) the degree to which the accountant could reasonably foresee that the impairment of third-party pecuniary interests would result in economic loss; and (5) the extent to which the accountant took those control measures and issued warning statements that could reasonably be expected from him in the given situation to avoid the economic loss. Besides the violation of the auditor's duty of care, the other requirements to ground a claim on Article 6:162 of the Dutch Civil Code must also be established. For instance, there must be a causal link between the auditor's violation of his duty of care and the incurred financial losses by the third party. The *Hoge Raad* eventually concluded in the *Vie d'Or* case that the Court of Appeal erred in finding that there was a causal link.

There are also strict requirements for legal claims against CRAs in the U.S., which again shows that the threat of liability does not automatically open the floodgates or lead to frivolous litigation against CRAs. A securities-fraud claim, for example, requires the

plaintiff to establish particular facts giving rise to a strong inference that a CRA knowingly or recklessly (1) failed to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its methodology for evaluating the credit risk, or (2) obtained reasonable verification that such an investigation was done by a source independent of the issuer.²²⁷

Similarly, plaintiffs also have to establish several elements in cases of common law fraud or negligent misrepresentation. Claims for negligent misrepresentation in some U.S. states require a “privity-like special relationship” between the CRA and investors.²²⁸ Claims for negligent misrepresentation have already been dismissed because there was no direct contact or communication between the investors and the CRA establishing a special relationship approaching privity.²²⁹ In other states, plaintiffs have to show that the rating was supplied with the intent to influence the investors or a particular class of investors to which he belongs in a specific transaction, without explicitly requiring a special or privity-like relationship.²³⁰

A common feature in claims of negligent misrepresentation against CRAs is that the investor who uses the rating has to be part of a limited class or select group of qualified investors, whose reliance on the rating was foreseeable to the CRA.²³¹ Actual knowledge of the

227. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, § 933(b), 124 Stat. 1376, 1884–85 (2010) (codified at 15 U.S.C. § 78u–4(b)(2)); see Fernicola & Goldstein, *supra* note 140; Pendergraft, *supra* note 140, at 511–31.

228. See *King Cty. v. IKB Deutsche Industriebank AG*, IKB, 863 F. Supp. 2d 288, 309–10 (S.D.N.Y. 2012) (holding that the relationship was privity-like because the CRAs (1) intended that the rating would be used by the plaintiffs to evaluate the SIV, (2) intended that the plaintiffs, who were members of a select group of qualified investors, would rely on the rating to evaluate the SIV and (3) prepared the rating with the “end and aim” to induce investors to invest in the SIV), *overruled in part by King Cty. v. IKB Deutsche Industriebank AG*, IKB, No. 09 Civ. 8387(SAS), 2012 WL 11896326 (S.D.N.Y. Sept. 28, 2012); see also Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. U. L. REV. 17, 17–65 (2003) (discussing the liability of the auditor); Marc P. Gergen, *Negligent Misrepresentation as Contract*, 101 CAL. L. REV. 953, 954–89 (2013).

229. *Anschutz Corp. v. Merrill Lynch & Co.*, 690 F.3d 98, 114 (2d Cir. 2012); *Fed. Home Loan Bank of Boston v. Ally Fin.*, No. 11–10952–GAO, 2013 WL 5466628, at *2 (D. Mass. Sept. 30, 2013); *Ohio Police & Fire Pension Fund v. Standard & Poor’s Fin. Serv. LLC*, 700 F.3d 829, 840 (6th Cir. 2012).

230. *Quinn v. McGraw-Hill Cos.*, 168 F.3d 331, 335–36 (7th Cir. 1999); *California Pub. Emps.’ Ret. Sys. v. Moody Inv’rs Serv., Inc.*, 172 Cal. Rptr. 3d 238, 252 (Cal. Ct. App. 2014).

231. *California Pub. Emps.’ Ret. Sys.*, 172 Cal. Rptr. 3d at 258; *King Cty.*, 863 F. Supp. 2d at 309–10; *In re Nat’l Century Fin. Enter.*, 580 F. Supp. 2d 630, 646–48 (S.D. Ohio 2008); *LaSalle Nat’l Bank v. Duff & Phelps Credit Rating Co.*, 951 F. Supp. 1071, 1092–96 (S.D.N.Y. 1996).

identity of each particular investor, however, is not necessary as long as the rating is created to target a select group of qualified investors instead of the “faceless”²³² investing public at large.²³³ Investors are not part of a limited class if the allegations suggest both a widespread availability of the securities and a widespread reliance on the ratings (e.g. because the securities were not offered through private placement to only a certain type of investor).²³⁴

Finally, claims for negligent misrepresentation or common law fraud can be dismissed if the investors did not justifiably or reasonably rely on the rating. The *Abu Dhabi* court, for instance, concluded that the plaintiffs reasonably relied on the ratings because the market at large, including sophisticated investors, has come to rely on ratings issued by independent CRAs given “their NRSRO status and access to non-public information that even sophisticated investors cannot obtain.”²³⁵ Similarly, the *CalPERS* court held that, contrary to the corporate market, investors in the structured finance market cannot reasonably develop their own informed opinions because there is insufficient public information to do so. Reliance on credit ratings is justified if investors are unable to conduct their own analysis or develop independent views about potential investments.²³⁶

It remains uncertain whether the Australian *Bathurst* decision will open the liability floodgates. That is because the court limited the circumstances in which a CRA can incur liability towards third parties.²³⁷ The class of persons to whom S&P owed a duty of care was ascertainable. More specifically, the class comprised of potential purchasers of the minimum \$500,000 subscription in the \$40 million issue of the notes. S&P also controlled several factors confining the

232. *Ohio Police & Fire Pension Fund*, 700 F.3d at 841.

233. *King Cty.*, 863 F. Supp. 2d at 309–10; *LaSalle Nat’l Bank*, 951 F. Supp. at 1093–94; see also *In re Nat’l Century Fin. Enter.*, 580 F. Supp. 2d at 647 (holding that misrepresentations to the general investing public are not actionable because this is not a limited class of persons whom the speaker intends to benefit or guide).

234. *Ohio Police & Fire Pension Fund v. Standard & Poor’s Fin. Serv. LLC*, 813 F. Supp. 2d 871, 880–82 (S.D. Ohio 2011), *aff’d* by *Ohio Police & Fire Pension Fund v. Standard & Poor’s Fin. Serv. LLC*, 700 F.3d 829 (6th Cir. 2012).

235. *Fed. Home Loan Bank of Boston v. Ally Fin., Inc.*, No. 11–10952–GAO, 2013 WL 5466631, at *3 (D. Mass. Sept. 30, 2013); *Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.*, 651 F. Supp. 2d 155, 180–81 (S.D.N.Y. 2009).

236. *California Pub. Emps.’ Ret. Sys. v. Moody Inv’rs Serv., Inc.*, 172 Cal. Rptr.3d 238, 261–62 (Cal. Ct. App. 2014); *Contra Quinn v. McGraw-Hill Cos.*, 168 F.3d 331, 336 (7th Cir. 1999) (affirming that Quinn could not show that he reasonably relied on the rating because he was an “experienced” banker who should have done “his own homework.”).

237. *Harding & Donovan*, *supra* note 6, at 193.

scope of potential liability (e.g. the amount of issued products to which the rating relates, the conditions to impose on the communication of any rating, and the ability to reduce or control its liability by downgrading or withdrawing the rating).²³⁸ On appeal, the court held that the liability was not indeterminate because S&P knew that the investors were members of a class, the essential characteristic of which was that each investor wanted to purchase the notes. In addition, the type of loss was foreseeable; it is the nature of the loss (e.g. losing the money invested in the notes) and not the precise amount that has to be taken into account.²³⁹ In other words, both the class of investors and the foreseeable loss were determined by the function that S&P undertook, which was “delineated by the purpose of the rating . . . and the known reasonable reliance.”²⁴⁰

All the above-mentioned examples show that it remains uncertain whether imposing fault-based liability would bankrupt CRAs as easily as some predict.²⁴¹ If the threat of unlimited liability may prevent CRAs from offering rating services and ultimately leading to the collapse of the rating market,²⁴² the question should not be whether or not to impose liability, but rather focus on the appropriate liability regime for CRAs. Some scholars, therefore, advocate strict or fault-based liability for CRAs with the possibility of capping their liability.²⁴³

238. *Bathurst* at paras. 2745–66; see also Banton & Theodorou, *supra* note 160, at 4.

239. *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65, paras. 585–595, 1257–1262 (Austral.); see also CLARKE & HARRY EDWARDS, LIABILITY OF CREDIT RATING AGENCIES CONFIRMED BY AUSTRALIAN APPEAL COURT, HERBERT SMITH FREEHILLS, BANKING LITIGATION E-BULLETIN (2014).

240. *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65, paragraph 1260.

241. See, e.g., Coffee, *supra* note 7, at 252.

242. Listokin & Taibleson, *supra* note 11, at 101.

243. See, e.g., Coffee, *supra* note 166 (proposing a modified form of strict liability for gatekeepers where they would act as insurers of their own certification but with an insurance policy capped at a realistic level); Harper, *supra* note 167, at 1968–71 (concluding that liability of CRAs in the context of structured products should be limited to a percentage or small multiple of the rating fees earned from the individual debt issue which the CRA improperly rated and the liability cap should also differ depending on the level of the CRA’s negligence); see also Haar, *supra* note 8, at 331–33 (concluding that liability caps based on disgorgement of the CRA’s profits may strike an adequate balance between the danger of macroeconomic harm created by reckless CRAs and the threat of a market freeze resulting from over-deterrence); Manns, *supra* note 44, at 1080–82 (favoring a limitation of the liability of CRAs to cases of gross negligence coupled with a liability cap based on a multiple of the annual rating fees); Paces & Romano, *supra* note 167 (advocating a strict liability regime which triggers CRAs to issue accurate ratings and introducing a damage cap based on objective factors to avoid

6. Other Arguments Favoring Liability of CRAs

There are three additional arguments why the threat of liability is the path that legislators should follow to increase the quality of credit ratings.

Firstly, some maintain that it remains unclear when exactly a credit rating can be qualified as inaccurate or “bad”. It is, therefore, difficult to determine when a CRA’s conduct can lead to liability.²⁴⁴ Although rating defaults are indeed inevitable, CRAs do not violate their contractual obligations merely because the rating turns out to be incorrect later. Issuing an incorrect rating is not per se a reason to hold CRAs liable. That is because rating agreements and codes of conduct stipulate that CRAs do not intend to guarantee the correctness of the rating.²⁴⁵ The EU Regulation on CRAs is also very clear in this regard; the business of rating involves a degree of assessment of complex economic factors. The use of different methodologies can lead to different ratings, none of which can be considered incorrect as such. In other words, CRAs will not violate their contractual obligations merely because the given rating does not correspond to the creditworthiness of the issuer or the financial product. It is only when the incorrect rating is the result of a CRA’s negligent or fraudulent violation of its contractual obligations that liability should

crushing liability); Scarso, *supra* note 167, at 162–89 (concluding that any limitation of liability should be fixed in a manner which is consistent with the primary goal of promoting competition between CRAs and deterring their misconduct while at the same time ensuring the stability of capital markets and fair compensation to the damaged parties).

244. Gudowski, *supra* note 18, at 131.

245. See STANDARD & POOR’S, STANDARD & POOR’S RATINGS SERVICES CODE OF CONDUCT, art. 7.2 (2013) (“Credit Ratings do not constitute investment, financial, or other advice. Credit Ratings are not recommendations to purchase, hold, or sell a particular Security or to make any other investment decision. Credit Ratings do not comment on the suitability of an investment for a particular investor and should not be relied on when making any investment decision. The assignment of a Credit Rating to a Rated Entity does not guarantee the performance of the Rated Entity. Standard & Poor’s does not act as an investment, financial, or other advisor to, and does not have a fiduciary relationship with, any Issuer, investor, or any other person. Credit Ratings are not verifiable statements of fact.”); see also MOODY’S INVESTORS SERVICE, CODE OF PROFESSIONAL CONDUCT, pt. II (2015) (“MIS adopts all necessary measures so that the information it uses in assigning a Credit Rating is of sufficient quality and from sources MIS considers to be reliable, including, when appropriate, independent third-party sources. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process. In assigning a Credit Rating, MIS is in no way providing a guarantee with regard to the accuracy, timeliness, or completeness of factual information reflected, or contained, in the Credit Rating or any related MIS publication”).

be imposed.²⁴⁶ In this regard, it can be argued that CRAs have several contractual obligations, namely issuing an independent credit rating and managing or minimizing conflicts of interest, ensuring that the information they use is of sufficient quality and from accurate and reliable sources, and using rigorous, systematic and continuous methodologies based on historical experience.

This is also illustrated in the Australian *Bathurst* case, where the question was not whether S&P had to give another and more correct rating. Rather, S&P did not develop its own model for rating CPDOs and instead relied on the model created by ABN Amro (the issuer of the notes). S&P did not give any consideration to the model risk when assigning the rating.²⁴⁷ S&P adopted a 15% volatility figure that had been provided to it by ABN Amro. There was no evidence that S&P checked the 15% volatility figure itself. However, S&P could have easily calculated the volatility and would then have realized that the correct figure was around 28%. As such, a CRA that acts reasonable and prudent would have done its own calculations and surely not have adopted a volatility figure of 15%.²⁴⁸ The court held that the analysis of S&P did not comprise of mere mistakes or errors of judgment. Rather, it “involve[d] failures of such a character that no reasonable ratings agency exercising reasonable care and skill could have committed in the rating of the CPDOs.” In sum, the “[rating] analysis was fundamentally flawed, unreasonable and irrational in numerous respects.”²⁴⁹

Secondly, from a legal-comparative point of view, the idea of holding CRAs liable is not surprising considering that other certifiers such as auditors or product certifiers can also incur liability when they provide incorrect, incomplete, or otherwise deficient information. In this regard, Partnoy concludes that the threat of liability has been an effective tool in encouraging accountability for certifiers. Gatekeepers are less likely to engage in negligent, reckless or fraudulent behavior

246. WYMEERSCH & KRUIHOF, *supra* note 2, at 376 (“This would mean that the attribution of a rating that does not correctly reflect the creditworthiness of the rated entity would not automatically or necessarily bring about the liability of the rating agency vis-à-vis its client, the rated entity. For a contractual claim against the rating agency to be successful, the rated entity would have to prove that the incorrect rating is the result of insufficient effort, negligence or more generally wrongful behavior of the rating agency”).

247. *Bathurst* at paras. 2547, 2555–90.

248. *Id.* at paras. 2611–2669; *see also* Banton & Theodorou, *supra* note 160, at 2–6; Harding & Donovan, *supra* note 6, at 192.

249. *Bathurst* at paragraph 2836.

if they are subject to a risk of liability. Such a threat of liability should, therefore, be expanded to include the activities of CRAs.²⁵⁰

The United States Congress happened to hear the results of this comparative analysis as the Dodd–Frank Act “reflects the sentiment”²⁵¹ that CRAs are indeed considered as gatekeepers in capital markets. Ratings have a systemic importance because they are relied upon by different market actors such as regulators and investors. CRAs play a pivotal role in capital formation, investor confidence and the efficient performance of the US economy. As a consequence, CRAs act as gatekeepers in the debt market just like securities analysts evaluate the quality of securities in the equity market and auditors review financial statements of companies. Considering that CRAs perform evaluative and analytical services on behalf of clients, in much the same way as do other gatekeepers, activities of CRAs have a fundamentally commercial character. As a consequence, CRAs should be subject to the same standards of liability and oversight that apply to auditors, securities analysts, and investment bankers. In addition, Congress also concluded that inaccurate ratings on structured financial products led to the 2008 financial crisis. The inaccuracy of credit ratings, therefore, “necessitates increased accountability on the part of credit rating agencies.”²⁵² In sum, these justifications are the basis to creating a private right of action against CRAs.²⁵³

Finally, the threat of civil liability for CRAs is the path that regulators and legislators decided to follow after the financial crisis. Reference is, for example, made to the liability regime in Article 35a of the EU Regulation on CRAs,²⁵⁴ to Section 939G of the Dodd–Frank Act repealing Rule 436(g) of the Securities Act introducing expert liability for CRAs²⁵⁵ and to Section 933(b) of the Dodd–Frank Act lessening the pleading requirements in private actions for

250. Aline Darbellay & Frank Partnoy, *Credit Rating Agencies and Regulatory Reform*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 273, 288–89 (Claire A. Hill, Brent H. McDonnell eds., 2012); Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* 14–16 (San Diego Legal Studies Paper NO. 09-014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1430608;

251. Grinshteyn, *supra* note 132, at 957.

252. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, § 931, 124 Stat. 1376, 1872 (2010) (codified at 15 U.S.C. § 78o–7 note).

253. Grinshteyn, *supra* note 132, at 957.

254. See discussion *supra* Part II.E.5.

255. *Id.*

securities fraud against CRAs.²⁵⁶ As such, legislators are path dependent and it might be easier and less costly to continue driving the highway of liability, instead of creating an entirely new byway, which might include the different innovative proposals discussed in Part II.²⁵⁷

IV. CONCLUSION

This article sheds light on proposals that have been suggested to increase the accuracy and quality of ratings. However, at the end of the road, there are different arguments for why the threat of holding CRAs liable triggers them to issue accurate credit ratings.²⁵⁸ Imposing liability seems to be the path that academics as well as policymakers in the United States and the European Union should follow. Time has come to start thinking about the different options for creating a liability regime for CRAs, and especially finding the appropriate ways to implement them. In essence, additional research should be conducted to find the “correct answer”²⁵⁹ on the question which liability regime best ensures that CRAs issue accurate ratings.

I suggest that additional research on the liability of CRAs should be conducted, thereby taking a legal comparative approach in three ways. Firstly, studies should be done to determine whether the liability regimes adopted by the European Union and United States for other certifiers (e.g. classification societies, auditors, or product certifiers in general) can be a source of inspiration to regulate the liability of CRAs. Secondly, the research should take a closer look at how CRAs are regulated and held liable in the U.S. and in some EU member states (e.g. France, Germany, and the UK). Finally, more research should address the question of whether a no-fault or a negligence-based liability system (with capping mechanisms if necessary) can be used to regulate the liability of CRAs.

256. *Id.*

257. See Oona A. Hathaway, *Path Dependence in the Law: The Course and Pattern of Legal Change in a Common Law System*, 86 IOWA L. REV. 101 (2001) (describing the concept of path dependency).

258. A. Brooke Murphy, *Credit Rating Immunity? How the Hands-Off Approach Toward Credit Rating Agencies Led to the Subprime Credit Crisis and the Need for Greater Accountability*, 62 OKLA. L. REV. 735, 789 (2010).

259. Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. U. L. REV. 17, 20 (2003).