RATING AGENCIES

RATING AGENCIES:
THEIR BUSINESS, REGULATION AND LIABILITY UNDER U.S., U.K. AND GERMAN LAW

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His doctorate thesis (*Abschreibungen zwischen Aufwands- und Subventionstatbestand, Europarechtliche und verfasssungsrechtliche Grenzen von Abschreibungstatbeständen* - Depreciations as expense or subsidy measure, European and German law restrictions, Duncker & Humblot, Berlin 2005) has been supervised by Professor Dr. Dr. Paul Kirchhof, former Justice at the German Constitutional Court.

"Prudential, rather than rules-based, oversight will also encourage, rather than penalize, the innovation in financial markets that has been an important contributor to economic growth… Increased litigation would likely have a chilling effect on rating agencies' willingness to express opinions that do not have the approval of some vested party."

Raymond W. McDaniel, Moody's Investors Service, Public Comment on Code of Conduct Fundamentals for Credit Rating Agencies, November 15, 2004, Page 2

"They [the rating agencies] are in effect market regulators but not agencies of the US government nor subject to any particular regulatory control of aspects, such as the qualifications and knowledge of their analysts, either by educational qualifications or some sort of examination like the bar-examination a lawyer is required to pass. The clear inadequacies of the NRSRO [nationally recognized statistical rating organization] nomination and control process lead one to post the thorny question, *Quis custodiet ipsos custodies*? (Who shall guard the guardians themselves?)"

Andrew Fight, *The ratings game* (New York, 2001), 224.

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List of Abbreviations and Terminology

Abbreviation/term	**Full spelling/Function**	**Further explanation (if applicable)**
$	US Dollar	
€	Euro	
§	Section	
A.M. Best	Rating Agency specializing in insurance companies and founded by Alfred M. Best in 1899 as the A.M. Best Company, Inc.	
ABS	Asset-backed Securities	
AFTE	Association of French Treasurers	
AG	Amtsgericht	*Court of First Instance*
AG	Aktiengesellschaft	*Publicly traded German company with a minimum capital of at least €50,000.*
Art.	Article	
BAFin	Bundesanstalt für Finanzdienstleistungsaufsicht	*German Financial Services Authority*
Basel II	Bank for International Settlements' "International Convergence of Capital Measurements and Capital Standards: A Revised Framework, June 2004"	*www.bis.org*
BCBS	Basel Committee on Banking Supervision	
BDB	Bundesverband der Banken	*Federation of German Banks*
BDI	Bundesverband Deutscher Industrie	*Federation of German Industry*
BGB	Bürgerliches Gesetzbuch	*German Civil Code, containing five "books." Among other elements, the code deals with the law of contracts and torts.*
BGH	Bundesgerichtshof	*German High Court. Germany has five specialized federal high courts (for private law matters the BGH, for social matters the Bundessozialgericht, for fiscal matters the Bundesfinanzhof, for administrative matters the Bundesverwaltungsgericht, and for labor litigation the Bundesarbeitsgericht). Litigants may, however, invoke a specialized appeal to the Constitutional Court (Bundesverfassungsgericht) if a lower court has misinterpreted the constitution.*
BGHZ	*BGH* Zivilrecht	*Official bulletin of the German High Court*

		regarding private law litigation.
BIS	Bank of International Settlements	
BörsenG	*BörsenGesetz*	*The German law on exchanges.*
Bündnis 90 / Grüne	Union of 1990 / Greens	*Environmentalist party of Germany*
BVA	Bundesversichungsamt	*Functionally this term can be translated as "Federal Social Security Supervi-sory"Agency.*
BVerwG	Bundesverwaltungsgericht	*German Federal High Court on administra-tive matters.*
BVerwGE	Bundesverwaltungsgerichtsent-scheidungen	*Official Gazette of decisions of the BVerwG*
BVI	Bundesverband Deutscher Invest-ment-Gesellschaften e.V.	*German association representing investment fund companies*
CBO	Collateralized Bond Obligations	
CDU	Christlich Demokratische Union	*Christian Democratic Party (conservative)*
CEBS	Commission of European Banking Supervisors	*The Committte is currently focusing on the implementation of the Capital Requirements Directive. 'http://www.c-ebs.org/*
CESR	Commission of European Securities Regulators	*"The Committee was established under the terms of the European Commission. s. Deci-sion of 6 June 2001 (2001/527/EC). It is one of the two committees envisaged in the Final Report of the Committee of Wise Men on the regulation of European securities markets, chaired by Baron Alexandre Lamfalussy." http://www.cesr-eu.org/*
CLO	Collateralized Loan Obligations	
CMBS	Commercial Mortgage Backed Se-curities	
D.	District	
DAJV	Deutsch-Amerikanische Juristen-vereinigung	*German-American Lawyers' Association*
DCR	Duff & Phelps	
DSGV	Deutscher Sparkassen und Girover-band	*Federation of German Savings-Banks*
EC Nr. L	Official bulletin of the European Community, part "L" (for laws)	
ECAI	External Credit Assessment Institu-tions	*Terminology of Basel II when referring to rating agencies.*
EC Nr. L	Official bulletin of the European Community, part "L" (for laws)	
ECOFIN	The Council of the European Union meeting as assembly of Economics	*http://www.consilium.europa.eu/cms3_fo/showPage.asp?id=250&lang=en*

	and Finance Ministers of the Member States, as well as Budget Ministers when budgetary issues are discussed. It meets once a month.	
Economies of scale		*A production process in which each increase in units of production decreases the average fixed cost per unit. Markets in which such economies are important tend towards ever greater market concentration.*
EEA	European Economic Area	*Agreement between the European Union and Norway, Iceland and Liechtenstein creating an internal market between all member states to the EEA Agreement.*
EGBGB	Einführungsgesetz zum Bürgerlichen Gesetzbuch	*Introductory Law to the German Civil Code. This law deals with the applicability of the Civil Code with respect to time and space.*
F.	Federal	
FAZ	Frankfurter Allgemeine Zeitung	*German newspaper*
FDP	Freie Demokratische Partei	*German Free Democrat Party (liberal)*
Fitch	Fitch Publishing Company	
FRCP	Federal Rules of Civil Procedure	
FSA	Financial Services Authority	*UK Financial Supervisor*
FSAP	Financial Services Action Plan of the European Commission	
FSMA	Financial Services and Markets Act 2000	*UK legislation on financial markets, please refer to page 125. [http://www.hm-treasury.gov. uk/documents-/financial_services/regulating_financial_services/fsma/rsf_fsma_index.cfm]*
Fungibility		*Interchangeable. In commercial law, this term describes that satisfaction is achieved through the delivery of an asset of a particular kind, rather than through the delivery of a specific asset. Securities traded on an exchange are fungible due to their standardized specifications for quality, quantity, delivery date, and delivery locations.*
G-10	The eleven industrial countries of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.	*Source: www.bis.org: "The Ministers of Finance and Central Bank Governors of the Group of Ten usually meet once a year in connection with the autumn meetings of the Interim Committee of the International Monetary Fund."*
GmbH	Gesellschaft mit beschränkter Haftung	*German corporation having a minimum capital of at least €25,000.*
GO	General Obligations	*NY State Consolidated Laws on General Obligations*

HGB	Handelsgesetzbuch	*German Code for commercial matters*
HR	House of Representatives	
ICI	Investment Company Institute	*"The Investment Company Institute (ICI) is the national association of the U.S. investent company industry. Founded in 1940, its membership includes approximately 8,500 mutual funds, 670 closed-end funds, 160 exchange-traded funds, and five sponsors of unit investment trusts." ttp://www.ici.org/newsroom/contacts.html*
IFD	Initiative für den Finanzstandort Deutschland	*Initiative of German banks to reinforce banking activities in Germany*
IMF	International Monetary Fund	
IOSCO	International Organization of Securities Commissions	
ISDA	International Swaps and Derivatives Association, Inc.	*A swap is a derivative, where two counterparties exchange one stream of cash flows against another stream. These streams are called the legs of the swap. The cash flows are calculated over a notional principal amount. Swaps are often used to hedge certain risks, for instance interest rate risk. Another use is speculation.* *ISDA is a an organization founded by market participants which fosters and promulgates the use of swaps notably by proposing standardized contractual agreements.*
KapInHaG	Kapitalinformationshaftungsgesetz	*The liability law relating to information about the capital markets (KapInHaG) was only proposed and never took effect.*
KG	Kommanditgesellschaft	*Limited partnership*
Alexandre Lamfalussy	Chairman of the Committee of Wise Men whose final report (Feb. 15 2001) on the Regulation of European Securities Markets proposed a four-step system to implement future financial legislation.	*www.cesr-eu.org*
LG	Landgericht	*District Court*
Ltd.	Limited	*Corporation having the status of a separate legal entity.*
MBS	Mortgage-Backed Securities	
MiFID	Markets in Financial Instruments Directive	*Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and*

		repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1)
Mittelstand	German term describing the mid-sized company segment, which is traditionally the stronghold of the German economy.	
NASDAQ	National Association of Securities Dealers Automated Quotations	
NJW	Neue Juristische Wochenzeitschrift	*Journal*
NRSRO	Nationally Recognized Statistical Rating Organization	*Terminology of the SEC used to refer to certain recognized rating agencies and employed for compliance purposes by the SEC and banks/funds. To date, only these "nationally recognized statistical rating organizations," or NRSROs, are: A.M. Best Company, Inc.; Dominion Bond Rating Service Limited; Fitch, Inc; Moody's Investors Service, Inc.; and the Standard & Poor's Division of the McGraw Hill Companies, Inc. qualify as NRSRO.* *The NRSRO designation has been replaced by "registration" under the Credit Rating Agency Reform Act of 2006.*
NSE	New York Stock Exchange	
NY	New York	
NZM	Neue Zeitschrift für Miet- und Wohnungsrecht	*Journal*
OLG	Oberlandesgericht	*Higher Regional Court*
OTC	Over the counter	*The over-the-counter market prevails in certain specialized financial markets which are not yet subject to standardization (a prime example is the international currency exchange).*
PD	Probability of Default	
Reg. FD	Regulation Fair Disclosure of the SEC	
REITs	Real Estate Investment Trusts	
RMBS	Residential Mortgage-Backed Securities	
s.	Section	
S&P	Standard & Poor's	
SAT	Scholastic Achievement Test	
SEC	Securities and Exchange Commission	*US Financial Supervisor*
Short/long		*To be long/short or to have a short/long position refers to the financial position of an*

		individual market participant. A market participant going "short" on an asset hopes the price of the investment will decline. A market participant going "long" hopes the price of an asset will rise. To profit from a decline, an investor can borrow a security, sell it to later buy it back or use derivatives (in this case a put) to "shorten" his position. What procedure an investor uses to go short/long is not revealed by the term.
SOX	Sarbanes-Oxley Act	
SPD	Sozialdemokratische Partei Deutschlands	*Social Democratic Party of Germany*
SPE	Special purpose entity	*Terminology of Basel II when referring to an SPV*
SPV	Special purpose vehicle	
Suppl.	Supplement	
TBW	Thomson Bank Watch	
TOEFL	Test of English as a Foreign Language	
UCC	Uniform Commercial Code	
UCITS	Undertakings for Collective Investment in Transferable Securities	*The Council Directive of December 20, 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities as amended defines UCTIS as "undertakings […]* *- the sole object of which is the collective investment in transferable securities […] from the public and which operates on the principle of risk-spreading and* *- the units of which are, at the request of holders, re-purchased or redeemed, directly or indirectly, out of those undertakings' assets. […]"* *A collective investment fund may apply for UCITS status in order to allow EU-wide marketing (so-called EU passport).* *[http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1985/L/01985L0611-20050413-en.pdf]*
UK	United Kingdom	
Underlying(s)	Underlying asset to a securitization	*Underlying in a securitization or in a derivatives transaction refers to the asset which is securitized through the transaction or which is taken as reference for the derivatives transaction.*

US	United States	
v.	versus	
VAG	Versicherungsaufsichtsgesetz	*Law on the supervision of insurance undertakings*
VAR	Value-at-risk	*Basel II requires greater adaptation to the actual risk incurred ("VAR")*
WM	Wertpapiermitteilungen	*Journal*
WpHG	Wertpapierhandelsgesetz	*German Act for the trading with securities, contains rules against insider trading and market manipulation.*
WuB	Entscheidungssammlung für Wirtschafts- und Bankrecht	*Loose-leaf collection of court decisions in economic and banking law.*
ZHR	Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht	*Journal*
ZIP	Zeitschrift für Wirtschaftsrecht	*Journal*

Preface

In June 2004, the Bank for International Settlements published the I*nternational Convergence of Capital Measurement and Capital Standards: A Revised Framework*, commonly referred to as Basel II. Basel II permits banks to use external ratings for the calculation of minimum regulatory capital. Shortly thereafter, in December 2004, the The Technical Committee of the International Organization of Securities Commissions agreed on the *Code of Conduct Fundamentals for Credit Rating Agencies* ("the IOSCO Code"). Both Basel II and the IOSCO-Code have heavily influenced new legislation on rating agencies both sides of the Atlantic.

In the EU, Basel II and IOSCO Code have been implemented through the (revised) Banking and the Capital Adequacy Directive. Both these Directives were published in the Official Journal on June 30, 2006 and required national implementation until December 31, 2006. The European Commission itself has by Communication (2006/C 59/02) decided not to act with respect to rating agencies but the EU's understanding of the recognition criteria for rating agencies have been specified by The Committee of European Banking Supervisors (CEBS) in the *Guidelines on the recognition of External Credit Institutions*.

Germany has implemented said Directives - with respect to rating agencies - by specifying the recognition criteria for rating agencies in sections 52, 53 of the Regulation on Banking Capital – *Solvabilitätsverordnung*, relying heavily on the works of CEBS. Similarly, the UK has implemented these directives by amending its Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU) in its section 3.6 on the *Use of rating agencies' credit assessments for the determination of risk weights under the standardised approach to credit risk*.

As of Sept. 29, 2006, the US has reformed its existing no-action letter-system to an overt recognition system by *The Credit Rating Agency Reform Act*.

Contrasting the U.S., U.K. and German perspective, this work is intended to show, how these various parameters should be applied, how the business of rating agencies is affected by regulation, and which criteria could be applied by the judiciary in litigation against rating agencies. Litigation and regulation do not go hand-in-hand in this field; whereas regulation has now been implemented, the existing legal parameters guiding (potential) liability of rating agencies remain disputed and vague.

The aim of the book is to establish common standards for rating agencies both for their regulation and liability. The challenge has been to find criteria for the judiciary to find on the correctness or incorrectness of ratings without allowing for a judicial second-guessing. The solution suggested here consists of limited supervision and judicial restraint. The book is also intended to allow for a better understanding of the economics and the legal framework of the rating industry. Even in traditional credit based financing, rating criteria will have to be followed, particularly so if the credit institution intends to syndicate the loan to others. In securitizations, the whole transaction structure is dependent on the approval by one or more rating agencies. Understanding the role and parameters for rating agencies should thus be of ever-increasing importance.

Business-oriented literature on the topic of ratings is abundant, but the legal questions that arise in connection with this subject remain largely unresolved. There is little, if any, comparative literature that relates to US, UK and German law, and apparently no literature that covers both legal and financial issues. This book is written from a finance point of view that comprises aspects from both the legal and the business world, making use, in the process, of both legal and business terminology. Thanks to statistical information granted from Moody's and S&P, it was possible to confront the analysis with statistical data.

A comparative law approach was used to increase awareness of contrasts between the three legal systems. The order of appearance follows the historic evolution of financial markets. Therefore, US law is first examined, before UK law and finally, German law.

US and UK law - not surprisingly - share many conceptual commonalities, albeit that US constitutional considerations with respect to the First Amendment and differing case law lead to distinctly different approaches. The German law analysis follows Code-based principles and thus applies deductive rather than inductive methods.

The view held here is that rating agencies cannot effectively shield themselves from potential liability through disclaimers but will have to observe a world-wide uniform standard of care based on the IOSCO Code of Conduct for Rating Agencies (reprinted as Appendix 1). The Courts should, however, apply limited judicial control of such a standard (cf. 9.1. Limited judicial control).

The IOSCO Code, the Rating Agencies Reform Act of 2006 and the Communication of the European Commission on Rating Agencies are reprinted here as Appendices for your convenience.

The importance of understanding the rating process is set to increase. According to the standardized approach allowed under Basel II, not only the issuers of securities but also medium-sized enterprises, known in Germany as the *Mittelstand*, will find themselves in an improved financial situation vis-à-vis their bank, irrespective of whether they opt to access the capital markets. As a consequence of this evolution, in April 2005 the world's largest rating agency, Moody's, announced a new rating service for small and medium-sized companies in Europe (see Global Credit Research Announcement, "Moody's: Neuer Rating-Service für den Mittelstand", April 28, 2005). An increase in the reputability of a company has

thereby become the key objective to be attained through a rating. This finding is further supported by the substantial number of issuers seeking more than two ratings, i.e. seeking more than the fulfillment of any regulatory requirements. A survey conducted in 2001 of 309 issuers showed that 55% of respondents were rated by three or more agencies. Two-thirds of all the financial sector respondents were rated by at least three rating agencies, and two-thirds of the issuers with four or more ratings were banks.

> Andrew Fight, *The ratings game* (New York, 2001), 154; quoting the results of a four-year survey beginning in 1996.

Knowledge of the rating process, of the criteria involved, and ultimately of the rating agencies themselves is thus primordial for the effective refinancing of a business. Even small banks or medium-sized enterprises might be well advised to enhance their understanding of this area and in light of such, this book is intended to serve as a reference for specific questions in this field.

Frankfurt am Main, May 2007 Oliver v. Schweinitz

1. Introduction

Credit agencies are powerful institutions, and owing to both the growing number of issuers and products (asset-backed securities, credit derivatives) as well as to the effects of globalization, their importance has increased.[1] The total global credit derivatives market alone was estimated by the FSA in 2001 to have been over $1 trillion, expanding rapidly from a base of $180 billion in 1997.[2] It has been estimated that roughly 80% of all capital streams are influenced by ratings.[3] The expansion of the use of ratings outside the United States is a relatively recent phenomenon. In the case of Germany, for example, Moody's Investor Service opened a branch in Frankfurt as late as 1991, and was followed by Standard & Poor's in 1992. Fitch has only been represented in Germany since 1999.[4]

Basel II, i.e. the Bank for International Settlements' "International Convergence of Capital Measurement and Capital Standards: A Revised Framework, June 2004,"[5] aims to individualize the risk adjustments of banks by making their capital

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[1] Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities] Markets (as required by Section 702(b) of the Sarbanes-Oxley Act of 2002), Pub. K. no.: 107-204, s. 702(b), 116 Stat 745 (2002), 5.

[2] Financial Services Authority, "Cross-sector risk transfers," Discussion Paper, May 2002, 3.

[3] Boris Hrubesch, Jürgen Witte, "Rechtsschutzmöglichkeiten beim Unternehmensrating," *Zeitschrift für Wirtschaft (ZIP)* no. 29, 2004, 1346 (1347).

[4] Boris Hrubesch, Jürgen Witte, "Rechtsschutzmöglichkeiten beim Unternehmensrating," *Zeitschrift für Wirtschaftsrecht (ZIP)* no. 29, 2004, 1346 (1347).

[5] Bank for International Settlements' "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," June 2004, generally known as the Basel II Framework. Basel II is the follow-up agreement to Basel I. Both Basel I and Basel II were elaborated by the BCBS, the Basel Committee of Banking Supervision. The BCBS is a committee of banking supervisory authorities which consists of senior representatives of commercial bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the US. The BCBS usually convenes at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent secretary's office is located.

requirements subject to the rating of borrowers; the mechanism of individualized capital requirements is called "value at risk" (VAR) evaluation.[6] Basel II has been implemented into European law through amendments to the Banking Directive and the Capital Adequacy Directive. Germany has implement said Directive, thereby implementing "Basel II" through amendments to the KWG (Act for the implementation of the new banking directive and the new capital adequacy directive of November 17 2006 - *Gesetz zur Umsetzung der neu gefassten Bankenrichtlinie und der neu gefassten Kapitaladäquanzrichtlinie vom 17. November 2006*) and the introduction of various regulations, notably the Regulation on Banking Capital (*Solvabilitätsverordnung*).[7] VAR estimates show that credit risk accounts for roughly 54% of the risk adjustment valuation:

Figure 1: Risk proportions

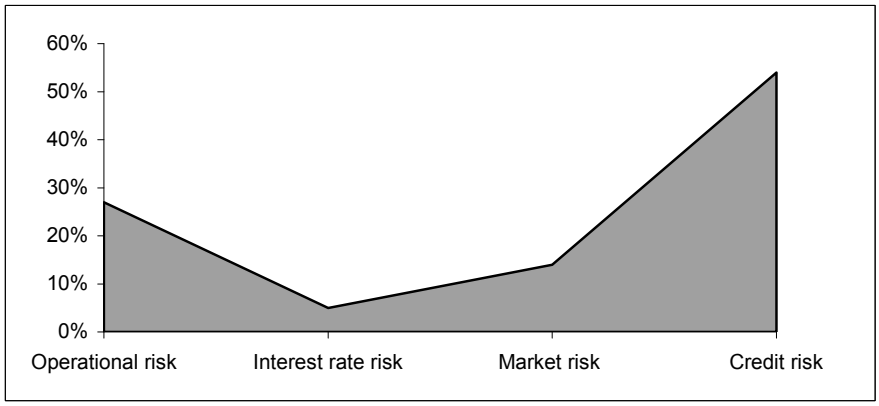
Operational risk	27%
Interest rate risk	5%
Market risk	14%
Credit risk[8]	54%

In 1975, following the bankruptcy of Bankhaus Herstatt, a German commercial bank, which left many foreign exchange obligations unfulfilled, the G-10 countries plus Luxembourg and Switzerland formed the BCBS.

[6] Its mathematical implementation is rather complex; for a mathematical analysis of Value-at-Risk (VAR) with Monte Carlo Simulation, see for example, Phillipe Jorion, "*Value At Risk. The New Benchmark for Managing Financial Risk: The Benchmark for Controlling Market Risk*", 2nd. ed., (New York: McGraw-Hill, 2000).

[7] Ministry of Finance, Gesetz zur Umsetzung der neu gefassten Bankenrichtlinie und der neu gefassten Kapitaladäquanzrichtlinie vom 17. November 2006:
http://www.bundesfinanzministerium.de/lang_de/sid_380A8F5BE4FCC9B506FD719E5313A525/DE/Geld__und__Kredit/Aktuelle__Gesetze/Entwurf__eines__Gesetzes__zur__Umsetzung__Bankenrichtlinie,templateId=renderPrint.html
Draft for a Law for the Implementation of the newly adapted banking directive and the newly adapted capital-adequacy directive, (BMF-Entwurf eines Gesetzes zur Umsetzung der neu gefassten bankenrichtlinie und der neu gefassten Kapitaladäquanzrichtlinie, VII B 3 – WK 5611/05/0001), February 6, 2006.

[8] Numbers taken from: Joel Bessis, *Risk Management in Banking*, (New York: John Wiley & Sons, 1998), 36.



It therefore seems very likely that Basel II will bring about changes within the rating industry. Previously, ratings were required for the issuance of individual securities (ratings focused thus solely on the risk of the individual issuance); following Basel II, (internal or external) ratings will be elaborated to include default risk evaluations of the borrowing entity itself.[9] This will probably have an effect not just on the credit business of banks but also on the investment banking business. Generally, the duration (and the thereon dependent interest structure) of a bank's receivables (=loans) is longer, than the duration of a bank's obligations (e.g. customers' current accounts). Thus, this mismatch in duration can create a liquidity risk for a bank. The activities traced in the "banking book", an accounting category containing the proprietary trading of a bank, and the ones reported in the "trading book", an accounting category for the trading of a bank on account of customers, should be connected so that the banking book may be used as an internal swap for a mismatched risk of the interest rate and duration of loans.[10] Thus, effec-

[9] In order to calculate the credit exposure, Monte Carlo simulations invented for option pricing models are used. The terminology "Monte Carlo" relates to the idea of repeatedly running identical (computer) simulations and displaying the stochastic result as an approximation of the expected outcome; cf. Charles W. Smithson, *Managing Financial Risk, A Guide to Derivative Products, Financial Engineering and Value Maximization,* 3rd ed., (New York: McGraw-Hill, 1998), 235 and 566/567.

[10] An [external] interest rate swap is a contract for the future exchange ("swap") of interest payments. Typically, a swap has a fixed and a variable consideration ("leg"). The payer of the fixed

tively, from the bank's perspective on its liquidity reserves the risks of one category of activity have consequences on the other category of activities. No segment of a bank's business can be fairly judged on a stand-alone basis. Consequently, the importance of ratings has not just increased in quantity, but also in quality.[11] This change in quality also becomes apparent in light of the effects of sovereign ratings (as ceilings to whole economies) and the need to evaluate country risk under Basel II.[12]

The importance of the rating business has also increased as rating procedure and methodology are currently applied not only to bonds and bond issuers, but to all kinds of financial products, for example to mutual funds.[13]

Issuers and investors alike regard ratings as constituting what could be considered the most sensitive information with regard to pricing a security. Without a

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leg is the payer, the other party is the receiver. Swaps are generally agreed for a term of 2 to 10 years. The bulk of swaps is traded over-the-counter (OTC) between banks, Rolf Beike, Andreas Köhler, *Risk-Management mit Finanzderivaten*, (München: Oldenbourg R. Verlag GmbH, 1997), 35.
For a more thorough explanation of internal swapping, cf. Dimitris N. Chorafas, *The Market Risk Amendment, Understanding the Marking -to-model and Value-at-Risk*, (New York: John Wiley & Sons, 1998), 36.

[11] Gudula Deipenbrock examines more precisely how the Basel II accords will be transposed into the European directive, "Aktuelle Rechtsfragen zur Regulierung des Ratingwesens," *WM* 2005, 261 (266).

[12] Stijn Claessens (University of Amsterdam), Geert Embrechts (Rabobank International), *Sovereign Ratings and Transfer Risk: External versus Internal Ratings*, 3. According to these authors country risk is the exposure to a loss in a cross-border lending, caused by events in a particular country that are – at least to some extent – under the control of the government, but definitely not under the control of a private enterprise or individual. Country risk is therefore a broader concept than sovereign risk, which is restricted to the risk of lending to the government of a sovereign nation.

[13] Michal Mann, analyst at the "Privates Institut für Fondsanalyse AG," expresses doubts about the prognosis quality of fund ratings. Michael Mann, "Mehr Vermutung denn Gewißheit, Die Prognosequalität von Fondsratings ist zweifelhaft," *Frankfurter Allgemeine Zeitung*, May 24, 2005, B15.

rating above investment grade[14] it may be impossible for the potential issuer to access the capital markets at all. Applicants use rating information to evaluate their potential employers. Issuers must therefore prepare diligently for the scrutiny of external rating agencies or bank-internal rating procedures following principles quite analogous to the one developed by rating agencies[15]. They do so by employing a new species of advisor: the rating advisor.[16]

While rating agencies still remain largely private, unregulated institutions, the Basel II rules will enable banks to adjust their capital requirements to the internally or externally rated degree of risk that is attached to a particular type of security. In this context, the Basel II rules contain provisions on the adequacy of "external credit assessment institutions" [ECAI].[17] This growing dominance of ratings might lead to a credit-crunch for small and medium-sized enterprises that have difficulties providing all the data traditionally required by rating agencies. The rating process as such might, therefore, force smaller and medium-sized enterprises to rely on venture capital rather than to seek financing from credit institutions.[18]

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[14] In the terminology of Moody's, investment grades range from "Aaa" to "Baa3," for S&P it is from "AAA" to "BBB-," Boris Hrubesch, Jürgen Witte, "Rechtsschutzmöglichkeiten beim Unternehmensrating, " *Zeitschrift für Wirtschaft (ZIP),* no. 29, 2004, 1347.

[15] Cf. the *BAFin* supervision of rating criteria, Guidelines for applications to use the IRBA for calculating minimum capital requirements, http://www.*BAFin*.de/irba-zul/zulassung_en.pdf (accessed June 1, 2006).

[16] In small to medium-sized entreprises the tax advisor is apparently quite often asked for advice, Maria Zeller, "Rating Advisory, Beraterpraxis," *DSWR*, 6/2005, 133.

[17] Ottmar Schneck shows the similarities between the Basel II and the IOSCO setting and discusses the current debate on how to implement these rules in the German legal system, "Keine Regulierung von Ratingagenturen," *DSWR*, 3/2005, 75 [76]; Anne Strunz-Happe explains the details of the ECAI regime, "Externe Ratingagenturen – Marktregulierung durch Basel II, - Vorgaben zur Anerkennung als ECAI und die aufsichtsrechtliche Behandlung externen Ratings," *WM* 3/2004, 115-120.

[18] Werner Gleißner, "Rating und Basel II, Chancen und Gefahren für den Mittelstand," *DSWR* 5/2005, 126-129.

All members of the Basel II accord are currently considering how the agreement should be implemented in national law.[19] Guidance in this respect by the Bank for International Settlements is detailed and highly technical[20] and as a result the US has already delayed its proposal for national implementation.[21] In the German case, the Ministry of Finance wants to delegate the task to the German Financial Services Authority, *BAFin*. *BAFin* is to define the requirements for complying with Basel II and, in so doing, will most likely stipulate the inclusion of ratings as a means of risk evaluation. *BAFin* is also considering adopting rules of professional conduct for rating agencies[22]. The Bundesbank has suggested a peer review model analogous to the one for chartered accountants.

A majority in the German Parliament also supports the soft-law regulation initiated by the International Organization of Securities Commissions, IOSCO.[23] IOSCO includes among its members regulators like the Securities and Exchange Commission (SEC), *BAFin* and the Financial Services Authority of the UK. The modus operandi at IOSCO is comparable to the commitology proceedings in Level

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[19] "Basel II liegt im Zeitplan, Neue Vorbehalte gegen Eigenkapitalempfehlungen für Banken sorgen *BAFin*-Chef nicht, " *Börsenzeitung,* May 20, 2005, 4.

[20] Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards, A revised framework," June 2004, Bank for International Settlement, ISBN: 92-9131-669-5, pages 1-251.

21 Press release of the Federal Reserve Board, April 29, 2005 (delayed national proposed rulemaking):
"The four federal banking agencies (the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision) today agreed that additional analysis is needed before publishing a notice of proposed rulemaking (NPR) with respect to the U.S. implementation of the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," generally known as the Basel II Framework."

[22] "Maßnahmenkatalog der Bundesregierung zur Stärkung der Unternehmensintegrität und des Anlegerschutzes." http://bmj.bund.de/enid/ai.html (accessed Feb. 25 2003).

[23] Press release of the German parliament on common proposal by the SPD, CDU/CSU, Bündnis 90/ Greens and FDP, no. 15/2815. http://www.bundestag.de/bic/hib/2004/2004_088/88 (accessed April 1, 2004).

II of the Lamfalussy[24] process. A draft is first published before market participants are consulted[25]; IOSCO has published its Code of Conduct Fundamentals for Credit Rating Agencies. Despite its name, the "Code" is non-binding.[26] However, the EU Commission has already given soft-law mandatory effect to the "Code" through ongoing supervision by CESR. It has stated[27]:

> "First of all, credit rating agencies should incorporate all the provisions of the IOSCO Code into their own internal Codes of Conduct. Where they chose not to do so, they must explain how their Code nevertheless gives effect to the provisions of the IOSCO Code. … It is imperative that credit rating agencies not only incorporate the IOSCO Code in their own Code of Conduct but also fully comply with the IOSCO Code by enforcing their Code of Conduct in daily practice. Therefore, it is important that CESR's annual report provides for a thorough assessment of the level of day to day application of the IOSCO Code in practice, including consultation of all stakeholders."

IOSCO does not have any legislative power and depends on its members to implement its proposals into national law. However, as in the case of the "abide or disclose" rule with regard to corporate governance codices, whether the market

[24] Mr. Alexandre Lamfalussy was the chairman of a commission installed by the European Commission to render its advice on how to implement the Financial Services Action plan. Its proposal entailed a four step system: Step 1: General EU directive or regulation. Step 2: Commitology proceedings for EU implementation measures. Step 3: Transposition into national law. Step 4: Surveillance and Enforcement. For more information see "Inter-Institutional Monitoring Group, First Interim Report Monitoring the New Process for Regulating Securities Markets in Europe (The Lamfalussy Process)," www.eu.gov.org (accessed May 2003).

[25] In this case so-called "Public Comments on Code of Conduct Fundamentals for Credit Rating Agencies"; the who-is-who of public interest groups and market players responded to the questionnaire.
Most market players basically agreed with the careful approach of the IOSCO rules; see for example, Vickie A Tillman, Standard & Poor's, "Public Comment on Code of Conduct Fundamentals for Credit Rating Agencies," November 8, 2004, 2; Raymond W. McDaniel, "Moody's Investors Service, Public Comment on Code of Conduct, Fundamentals for Credit Rating Agencies," November 15, 2004, 2.

[26] On this deficiency and the lack of efficient sanctions, cf. Matthias Habersack, "Rechtsfragen des Emittenten-Ratings," *ZHR* 169 (2005), 185-211 [192].

[27] European Commission, Annual Report on Credit Rating Agencies, May 17, 2006, MARKT/FF/D(2006) 6428.

will enforce abidance to the "Code" remains to be seen. The business community has already indicated that it would "follow up to see how the various agencies seek to implement the Code's provisions."[28]

In any case, in the EU the marge of discretion of rating agencies is decreasing. This evolution is by no means exception. Other players in the financial markets have become subject to increased scrutiny be means of the Markets in Financial Instruments Directive (MiFID). The MiFID imposes on *investment firms*[29] to disclose any remuneration received from persons other than their clients when rendering individual advice.[30]

In the US, SEC is scrutinizing rating agencies as a result of the Sarbanes-Oxley Act. According to Section 702 of the Sarbanes-Oxley Act, SEC will conduct a study of the role and function of credit rating agencies in the operation of the securities market.[31]

Outside the US, Germany and Japan in particular have begun to complain about the dominance of the three leading (US based) rating agencies: Moody's, Standard & Poor's (S&P), and Fitch. Moody's and S&P have a combined market share in excess of 80%, while Fitch's market share is approximately 14%.[32]

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[28] Sir Adam Ridley, "London Investment Banking Association," Annual Report 2004, 9; www.liba.org.uk.

[29] MiFID applies only to investment firms and regulated markets (Art. 1) . Art. 4 para. (1) MiFID defines: "'investment firm' means any legal person whose regular occupation is the provision of one or more investment services to third parties and/or the performance of one or more activities on a professional basis" Investment services are defined in Annex I to MiFID to include (among others) investment advice.

[30] Art. 4 para. (4) MiFID: "'Investment advice' means the provision of personal recommendation to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments;"

[31] Cf. page 68 et seq. for a more in-depth explanation of the impact of Sarbanes-Oxley on rating agencies.

[32] Jenny Wiggins, "A Chance to Step Into the Light," *Financial Times,* December 9, 2001, at IT 10.

Moody's alone rates bonds worth more than $30 billion in more than 100 sovereign states.[33]

Masaj Shiokawa, the Minister of Finance of Japan, criticized the downgrading of the credit risk of his government's outstanding bonds and announced legal steps in response. [34]The above-mentioned criticism should not be taken lightly. In the past, rating agencies have probably favored UK and US issuers.[35] The regulatory grip on rating agencies is, therefore, slowly increasing. This paper contends that rating agencies should not be subject to extensive regulatory supervision as this might threaten their objectivity. The various regulatory proposals, however, will not deal with the issue of the liability of rating agencies for wrongful ratings.

Some authors have argued that rating agencies will do everything in their power to avoid inadequate ratings, despite the apparent asymmetric information in

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[33] Guido Leidig, *Leistungsprofile von Rating-Agenturen, Bundesverband Druck und Medien e. V., Abteilung Betriebswirtschaft*, (Wiesbaden 2003), 30.

[34] Cf. the complaint letter of Japanese Ministry of Finance at
http://www.mof.go.jp/jouhou/kokusai/p140430ecov.htm;
Ottmar Schneck, professor at the European Business School,
http://content.bfinance.de/bfinance/de/Bfcontent.nsh(allnewsarticles2/; still more provocative is the criticism of Thailand's Deputy Prime Minister in the Thai newspaper *The Nation* following Moody's announcement of a review of Thailand's credit rating in February 1997: "The name of the firm itself is inauspicious. I have heard that the company's financial status is no good and it has to rely on extortion. When a country doesn't give it what it wants, the company tries to destroy the country. […] in the past, there was no such crazy rating firm and we lived. Since they are trying to destroy us, why can't we try to destroy them?" Cited by Roman Kräussl, "Sovereign Risk, Credit Ratings and the recent financial crises in Emerging Markets, Empirical Analysis and Policy Implications," *Schriftenreihe des Center for Financial Studies an der Johann Wolfgange Goethe-Universität Frankfurt am Main, Monographien XVIII,* (Frankfurt am Main 2003), 5.

[35] The Japanese Ministry of Finance contends that sovereign bonds should not be assessed solely by fiscal indicators, but comprehensively and in the broader context of the economy at large. It complains that Japan's saving surplus (the largest in the world), the refinancing of debt in the domestic market, the current account surplus and the foreign exchange reserves (largest in the world) are not taken into account. On the other hand, it alleges that the ratings for UK and US bonds have occasionally been too optimistic. According to the complaint, UK foreign currency bonds were rated AAA in 1978 only two years after the sterling crisis and [IMF] Fund borrowing in 1976. US Treasury bonds, on the other hand, maintained AAA status in the mid-80's when the sustainability of the US twin deficits was suspect.

bond issuances and the apparent conflict of interest. Although the risk of abuse cannot be completely ruled out, it will be demonstrated that for economic reasons, it is unlikely that Moody's or S&P will abuse their powers (section 2.6. The economic unlikelihood of the risk of abuse). This claim is based on the assumption that the dominant rating agencies will go to great lengths to protect their reputation.

However, it may be reasonably argued that the probability of abuse is negatively correlated to competitive pressure. At least in certain capital markets where the "two-rating-agencies rule" is not well established, a certain risk of abuse will, therefore, persist. Even in well-developed capital markets, cases have been reported in which rating agencies have failed miserably in their task. The SEC reacts to these failures through the establishment of a number of regulations.

If such risk of abuse cannot be avoided by the economic incentives of the rating business, the legal rules of the rating business will have to decide on the liability of rating agencies for wrongful ratings. Last but not least a concrete proposal for both a regime of administrative regulation (9.2. Limited administrative control) and for a regime of liability (9.1. Limited judicial control) will be made.

2. The Economic Rules of the Rating Business

This chapter investigates the reason for the existence of rating agencies, i.e. the asymmetric information problems apparent in bond issuances.

Typically, ratings are solicited, which means that they are requested and paid for by the issuer. As a result of this procedure, the rating agency gains access to confidential information. "Section 2.2. Confidentiality issues in securitizations" deals with the confidentiality issues relevant in this field, and in particular, with the decision of the Frankfurt's Regional High Court, which argued that for non-commercial debtors an implicit confidentiality clause with the bank would lead to the non-assignability of such claims. The decision in question is compared to the stance adopted by *BAFin* on issues of confidentiality. Much of the securitization market in Germany is, therefore, still dominated by synthetic securitization, i.e. where no real transfer of assets takes place and it is only the financial risk that is transferred to the "buyer" of the securitized asset.

Section 2.3. on "The rating hierarchy" deals with the quality levels of ratings that an issuer may obtain. The terminology of Moody's and S&P, in particular, is linked to the standardized approach for the measurement of capital requirements under Basel II. Additionally, the proposal of the German banks to agree on a common internal rating system under the so-called IFD platform (*Initiative für den Finanzstandort Deutschland* platform, which is an initiative supporting Germany as a financial center) is explained. The step system of such ratings is then linked to the statistical data on ratings to provide a better picture of how the letter-based system appears in empirical numbers of default.[1]

[1] It should be noted that rating agencies are very careful not to associate absolute probabilities of default to issuers' ratings. Rather, rating agencies argue that they create a world-wide relative ranking of the ability to pay back outstanding debt. For both the issuer and the purchaser of

Ratings and securitization are closely related. The relationship between these two issues and the functioning of securitization are explained in section 2.4. Securitization."

Rating agencies are typically paid by the issuer. The issuer would, however, have no economic incentive to pay for a rating lower than desired. He may try influence the rating agency with a bribe to obtain a better rating or by withholding payment in case of a lower rating. Therefore, in order to correctly perform their rating function, rating agencies must resist pressure from the issuer.

such debt, it is, however, imperative to attach concrete numbers to his or her own probability of default. Cf. Roman Kräussl, "Sovereign Risk, Credit Ratings and the recent financial crises in Emerging Markets, Empirical Analysis and Policy Implications," *Schriftenreihe des Center for Financial Studies an der Johann Wolfgange Goethe-Universität Frankfurt am Main, Monographien XVIII*, (Frankfurt am Main 2003), 23 and 32 (on the notion of world-wide comparability).

2.1. Information externalities in bond issuances

Asymmetric information is one of the basic problems of any market. It leads to adverse selection (before entering into the contractual agreement) and moral hazard (once having entered into the agreement). Both phenomena have given rise to extensive research.[2]

In loan transactions both problems are inherent. The example usually used by way of illustration is drawn from the used car market. Nobel-prize winner George Akerlof asked the simple question: How does the buyer avoid the lemon, i.e. a used car with defects in a used-car sale? Since buyers do not have the means to avoid a lemon, they are forced to assume the vendor will try to cheat them and will therefore only be able to agree on a price corresponding to a lemon. As a result, the price for used cars will be unattractive to the sellers of "good" cars. This will lead to a vicious circle and as a result of the information discrepancy, in the end only "lemons" will crowd the market and the used-car market may eventually dry out.[3]

Similar problems occur in other situations arising out of asymmetric information, such as the loan market. As in the car-sale analogy, the borrower has more information about his true credit-worthiness. Owing to the information discrepancy, the investor rationally has to assume the issuer to be a lemon; as a result, the price of borrowing will increase to unattractive levels, driving out the "good" borrowers.

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[2] Cf. Roman Kräussl for further information. Roman Kräussl, "Sovereign Risk, Credit Ratings and the recent financial crises in Emerging Markets, Empirical Analysis and Policy Implications," *Schriftenreihe des Center for Financial Studies an der Johann Wolfgange Goethe-Universität Frankfurt am Main, Monographien XVIII*, (Frankfurt am Main 2003), 6-12.

[3] George Akerlof, "The Market for Lemons: Qualitative Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84, 488-500.

The problem is further enhanced in the case of borrowing through the issuance of securities. Unlike a bank-loan situation, in a bond issuance, the lender has no personal contact with the issuer. It is virtually impossible for the lender to be sure as to whether or not the information he is given is reliable. Any bond issue, therefore, has a potential risk for the lender, who will thus tend to assume that any bond issued is "a lemon."

In a loan situation, the borrower has little means with which to convince the market of his willingness and ability to repay the loan. The more means the borrower uses to convince the market of his credit-worthiness, the more the market will assume that the borrower is desperately trying to refinance his bankrupt business. If he securitizes his "I owe you" with a negotiable instrument, at least he enables the buyer/lender to procure a title for himself by easier means. The underlying problem of asymmetric information, however, is not solved.[4] Thus, the credit market will not price the bond issues efficiently as long as asymmetric information persists.

Furthermore, in such equilibrium of imperfect information, the costs of information will not only be borne by the individual lender who invests in "bad" issuers of securities, but by the market as a whole. Thus, some of the costs will be assumed by "good" borrowers, who will be subjected to credit rationing by rationally acting lenders.[5]

The officially stated purpose of credit agencies is, thus, to reduce asymmetric information in credit issuances. In their early history, rating agen-

[4] The Federation of German Industries (Bundesverband Deutscher Industrie – BDI) hails the beneficial effects of rating agencies to reduce such asymmetries of information, but asks if there is an insufficiency of checks and balances, Public Comment on "Code of Conduct Fundamentals for Credit Rating Agencies," http://www.bdi-online.de (accessed November 5, 2004).

[5] Dwight M. Jaffee and Thomas Russel, "Imperfect information, uncertainty, and credit rationing," *Quarterly Journal of Economics*, 90, (1976), 651-666.

cies were paid by the purchasers of information and provided "screening"[6] on their behalf. Later, rating agencies began to charge issuers for their services (thereby providing "signalling"[7] devices to the capital markets). While ratings are primarily said to serve the information needs of the capital markets, they also serve as a source of useful information for the issuer's management itself. The financial officer of the issuer has to decide how to finance the venture. The rating tells him whether he has to adjust the equity-debt leverage. Despite the tax advantages attached to the use of debt, firms tend not to adopt extremely leveraged capital structures. Instead, they prefer a leverage that is adapted to the economic risks involved. A rating is a useful tool for finding out about the market's perception of such risks.[8]

In this context, rating agencies – assuming they effectively add information and do not simply sell a license to do business – provide a public service that creates a positive externality for the general public who benefits from the service without being charged for the information provided.[9] By specializing in a standard product, the assessment of credit risk, rating agencies realize economies of scale.[10] Often, the interaction between ratings and issuers is so intense that the entire financial product is geared towards the requirements of the rating agency at hand. This, in turn, may even lead to the standardization of financial

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[6] John Riley, "Silver Signals: Twenty-Five Years of Screening and Signalling," *Journal of Economic Literature* 39, (2001), 432-478.
[7] Cf. A. M. Spence, "Job Market Signalling," *Quarterly Journal of Economics* 87, (1973), 355-374.
[8] Taken almost literally from the abstract of Haim Levy, Marshall Sarnat, "Bankruptcy Risk and the Choice of Financial Structure," *discussion paper series*, International Institute of Management, Berlin 1977.
[9] Roy C. Smith and Ingo Walter, draft of "Rating Agencies: Is There an Agency Issue?," *Stern School of Business, New York University,* (February 18, 2001), 43.
[10] Volker Heischkamp, Stephan Lowis, "Kommunikation mit Ratingagenturen," pages 405-417 in: *Grundlagen und Implikationen von Ratings für Agenturen, Investoren und geratete Unternehmen*, (eds. Kirstin Achtleitner and Oliver Everling), (Wiesbaden: Gabler Verlag, 2005).

products as rating agencies publish their requirements (for example, for a true-sale securitization) beforehand in policies, reports or advisories. A partial public benefit derived from the use of ratings may also lie in the economies of scale and increasing comparability associated with standardization.

It is also not uncommon to see so-called "trigger clauses" contained in lending agreements. A trigger clause provides for enforcement rights[11] or information duties if a certain rating action is taken. Usually, trigger-clauses come into effect only in the event of rating downgrades, which may partially explain why downgrades have shown a greater impact on the capital markets than up-grades.[12]

Ratings are not just restricted to the financial world. Analogous problems of comparability and asymmetric information occur during the admissions process for colleges and are solved by standardized tests like the Scholastic Achievement Test (SAT) or, in the case of international students, the Test of English as a Foreign Language (TOEFL).[13]

In Germany, the *Stiftung Warentest* (foundation for the testing of consumer products) performs a similar function.[14] Research on the role of rating agencies in the functioning of emerging market economies suggests that the ef-

[11] For example, the increase of the rate of interest, the right to ask for further security or to terminate a lending agreement, Matthias Habersack, "Rechtsfragen des Emittenten-Ratings," *ZHR* 169 (2005), 185-211 [188].

[12] Roman Kräussl, "Do Credit Rating Agencies Add to the Dynamics of Emerging Market Crises?, *Center for Financial Studies Working Paper* no. 2003/18, edited by Jan Pieter Krahnen and Volker Wieland, (Frankfurt am Main 2003), 34.

[13] This comparison of ratings with the SAT was suggested by Lawrence White, "Capital Markets hearing," http://financialservices.house.gov/media/pdf/108-18.pdf.

[14] Matthias Habersack, however, questions their similarity; he notes that in the case of Stiftung Warentest, the foundation is not paid for its quality assessment and thus is not subject to the same type of pressure rating agencies may potentially be exposed to: "Rechtsfragen des Emittenten-Ratings," *ZHR* 169 (2005), 185-211 (191).

fect of ratings (and the responsibility[15] of rating agencies) is greater in markets with a greater degree of asymmetric information.[16]

2.2. Confidentiality issues in securitizations

In order to render their services, rating agencies have privileged access to information. The word "privileged" in this context carries a double meaning. First, rating agencies have privileged access to information as the issuer will naturally try to demonstrate its financial strength through documentation. Second, rating agencies are often privileged *strictu sensu*, i.e. the law grants them special rights to information which are not granted to others (especially insider rights). The SEC, for example, exempts rating agencies (like attorneys, accountants, the press, governmental agencies and others) from the prohibitions of selective disclosure through Regulation FD ("fair disclosure"). Naturally, however, rating agencies are bound by the rules against insider dealing and market manipulation.[17]

However, while banks are bound to observe the confidentiality of their client relationship, no such clear-cut principles exist for rating agencies. The principle of "banking secrecy" applies to two distinctly different targets: on the one hand, banks are to protect all client information from being accessed by

[15] Jeffery D Amato, Craig H Furfine (Federal Reserve Bank of Chicago), "Are credit ratings procyclical", *Bank for International Settlements, Working Paper* no. 129, 12. This work argues that caution is warranted with regard to findings suggesting the insensitivity of ratings to the business cycle.

[16] Roman Kräussl, "Do Credit Rating Agencies Add to the Dynamics of Emerging Market Crises?," *Center for Financial Studies Working Paper* no. 2003/18*,* eds Jan Pieter Krahnen and Volker Wieland, (Frankfurt am Main 2003,) 34.

[17] Rating Agencies and the employees working at these insitutions will be bound by the Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse). Official Journal L 096 , 12/04/2003 P. 0016 – 0025 (and the various national implementation of the directive).

third parties, in particular the public authorities; on the other hand, banks are not to actively disclose any information on the client to third parties.[18]

The general contract clauses of German banks typically contain a provision relating to banking confidentiality. In a contended decision of the Frankfurt Regional High Court (Oberlandesgericht), the Court argued that the confidentiality clause would implicitly contain a prohibition against assigning claims arising out of the client relationship to third parties.[19] With respect to non-commercial clients, such a contractual obligation not to assign claims in such cases would lead to the non-transferability of a claim.[20] "Section 402 *BGB* obliges the assignor to disclose all necessary information to enforce the claim. The Regional High Court held the view that this obligation would contradict the implicit confidentiality agreement which existed between a bank and its clients. Thus, in the view of the Regional High Court the bank could not validly assign its claims without breaching the confidentiality obligation. As a result, the Regional High Court argued, any attempt by a bank to assign its claims despite the confidentiality obligation would fail. In practice, claims by banks were thereby rendered un-assignable.

The decision of the Regional High Court has received much criticism.[21] It is outside the scope of this analysis to examine the details of this criticism.

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[18] Andreas Cahn, "Bankgeheimnis und Forderungsverwertung, Institute for Law and Finance," *Institute for Law and Finance,* W*orking Paper Series*, no. 32, August 2004, 4.

[19] Oberlandesgericht Frankfurt, Wertpapiermitteilungen (WM), 2004, 1386, 1387 f. (18 U 84/04 as of 25.5.2004).

[20] For loans among merchants, s. 354a *HGB* provides that such a clause does not affect the validity of the transfer of creditorship. The clause of non-assignability among merchants is, thus, just an obligation, but has no effect vis-à-vis third parties.

[21] Jens Rinze and Klaudius Heda, "Non-performing loan und Verbriefungs-Transaktionen: Bankgeheimnis, Datenschutz, § 203 StGB und Abtretung," Wertpapiermitteilungen 2004, 1557 (1566); Stefan Hofmann and Bernhard Walter, "Die Veräußerung Not leidender Kredite – aktives Risikomanagement der Bank im Spannungsverhältnis zwischen Bankgeheimnis und Datenschutz," Wertpapiermitteilungen 2004, 1566 (1571); Andreas Cahn, "Bankgeheimnis und Forderungsverwertung, Institute for Law and Finance," *Institute for Law and Finance, Working Paper Series*, no. 32, August 2004, 20.

However, the decision is important in so far as it may lead issuers to rely on "synthetic" securitization rather than "true sale" securitizations. A securitization is called "synthetic" if, through a combination of contracts, the economic result of a true sale securitization is achieved, although formally ownership to the underlying does not change hand. In synthetic securitizations, the credit risk of the underlying is transferred through credit-default swaps. Owing to market practices, the International Swaps and Derivatives Association, inc. (ISDA) recommends that only insolvency risks be swapped and not risks related to late payments.[22]

Whichever way legal practice chooses to cope with the decision of the Regional High Court, the issue of confidentiality has been raised and will haunt future asset-backed securitizations in Germany.

Rating agencies and other experts can serve as useful intermediaries in this context to alleviate the problems related to confidentiality. *BAFin* has allowed for limited disclosure to such experts in the context of asset-backed securities. In a circular on "the sale of claims on clients in the context of asset-backed securities transactions through German credit institutions" from March 19, 1997 (circular 4/97, number III) *BAFin* stated:

> "The tradition of access to data of the creditor is allowed without permission
>
> > if this data is indicated in encrypted form in order to satisfy the real property principle of clear determination for the transfer of claims and for the possibly necessary sound enforcement by the claimant and if the decryption is deposited at a neutral place (notary, German credit institution or other credit institution subject

[22] Hendryk Braun, "Klassifizierung von Asset-Backed-Securities," in *Praktiker Handbuch Asset-Backed-Securities und Kreditderivate, Strukturen, Preisbildung, Anwendungsmöglichkeiten, aufsichtliche Behandlung,*" eds. Josef Gruber, Walter Gruber and Hendryk Braun, (Stuttgart: Schäffer-Poeschel Verlag, 2005), 61 (69),

to EC banking directive or resident in the European Economic Area)

or

if the tradition of providing third-party (**rating-agency**, certified public accountant, trustee) access **is unconditionally necessary in the context of ABS-transactions for technical reasons** (identity of client is not disclosed). The third parties are themselves bound to respect the confidentiality."

Rating agencies may, thus, also be used not only to decrease the asymmetric information in capital markets but also to mitigate issues of confidentiality. For example, owing to the use of rating agencies and other experts in a securitization through auction process, rating agencies may be used to disclose information at a much later stage of the proceedings than would otherwise be necessary to allow for a due diligence of the underlying.

2.3. The rating hierarchy

Ratings are a statement of opinion on the possibility of credit risk of an issuer or a particular issuance. Credit risk refers to the risk that the issuer cannot repay the interest on a loan at the due date or the principal at redemption. It is also called financial risk because it depends on the financial abilities of the issuer.[23] The focus of the analysis which the rating process entails is credit risk, but since many risks are correlated with one another, the rating analysis may also include other types of risk if related to credit risk.

Ratings only serve their purpose if they are comparable. Thus, the three dominant rating agencies have by and large agreed on a (world-wide applicable) common scale. The best rating an issuer can achieve and which is usually reserved for sovereign debt of countries like the US, Germany or the UK is

[23] "The Handbook of Fixed Income Securities," sixth edition, ed. Frank J. Fabozzi, Chapter 11, (New York: Irwin Professional Pub. 2000), 272.

"AAA." Down to BBB- or Baa3 in Moody's terminology, the issuance is regarded as being "investment grade." With a rating of BB+ or Ba1 (Moody's), the investment is regarded as distinctly speculative; in the cases of C and D, investments are predominantly speculative.

Due to the relevance of risk weighting under Basel II's standardized approach to the measurement of capital requirements, references to Basel II categories are included here. The Bank for International Settlements has proposed a number of minimum criteria in selecting financial institutions eligible to generate credit risk ratings for use in the Basel II risk-weighting scheme. The criteria for "External Credit Assessment Institutions" (ECAI) are indicated in the Figure 2 below[24]:

Figure 2: Criteria for Eligible External Credit Assessments Institutions

*"*An ECAI must satisfy each of the following six criteria:

Objectivity:	The methodology for assigning credit assessments must be rigorous, systematic, and subject to some form of validation based on historical experience. Moreover, assessments must be subject to ongoing review and responsive to changes in financial condition. Before being recognized by supervisors, an assessment methodology for each market segment, including rigorous back testing, must have been established for at least one year, and preferably three years.
Independence:	An ECAI should be independent and should not be subject to political or economic pressures that may

[24] Bank for International Settlements' "International Convergence of Capital Measurement and Capital Standards: A Revised Framework, June 2004" generally known as the Basel II Framework, part B 2, number 91, page 23.

	influence the rating. The assessment process should be as free as possible from any constraints that could arise in situations where the composition of the board of directors or the shareholder structure of the assessment institution may be seen as creating a conflict of interest.
International access/ Transparency:	The individual assessments should be available to both domestic and foreign institutions with legitimate interests and at equivalent terms. In addition, the general methodology used by the ECAI should be publicly available.
Disclosure:	An ECAI should disclose the following information: Its assessment methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the assessments, e.g. the likelihood of AA ratings becoming A over time.
Resources:	An ECAI should have sufficient resources to carry out high quality assessments. Theses resources should allow for substantial ongoing contact with senior and operational levels within the entities assessed in order to add value to the credit assessments. Such assessments should be based on methodologies combining qualitative and quantitative approaches.
Credibility:	To some extent, credibility will be derived from the criteria above. In addition, the reliance on an ECAI's external credit assessments by independent parties (investors, insurers, trading partners) is evidence of the credibility of the assessments of an ECAI. The credibility of an ECAI is also underpinned by the existence of internal procedures to prevent the misuse of confidential information. In order to be eligible for recognition, an ECAI does not have to assess firms in more than one country."

Short-term debt securities, such as commercial paper,[25] are rated on a different scale (A-1, A-2, A-3 and below at S&P, for example). Certain rating agencies view their rating as worldwide standards conveying the same level of risk irrespective of the jurisdiction in which the securities are issued.[26]

[25] An unsecured obligation issued by a corporation or bank to finance its short-term credit needs, such as accounts receivable and inventory. Maturities typically range from 2 to 270 days. Commercial paper is available in a wide range of denominations, can be either discounted or interest-bearing, and usually has a limited or nonexistent secondary market. Commercial paper is usually issued by companies with high credit ratings, meaning that the investment is almost always relatively low risk. http://www.investorwords.com/961/commercial_paper.html

[26] Referring to Standard & Poor's: Steven L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox." *University of Illinois Law Review*, issue no. 1, 2002, 9-10

Figure 3: The rating hierarchy[27]

Moody's	*S&P*	*Fitch*	*Brief Definition*	**Risk weighted Basel II standard approach[28] for claims on:**		
				securitized instruments[29]	**corporations[30]**	**Sovereigns[31]**
Investment Grade – High Creditworthiness				Long-term[32]		
Aaa	*AAA*	*AAA*	*Gilt edge, prime, max. safety*	20%	20%	0%
Aa1	*AA+*	*AA+*	*Very high grade, high quality*			
Aa2	*AA*	*AA*	*Very high grade, high quality*			
Aa2	*AA-*	*AA-*				
A1	*A+*	*A+*		50%	50%	20%
A2	*A*	*A*	*Upper medium grade*			
A3	*A-*	*A-*				
Baa1	*BBB+*	*BBB+*		100%	100%	50%
Baa2	*BBB*	*BBB*	*Lower medium grade*			
Baa3	*BBB-*	*BBB-*				
Distinctly Speculative – Low Creditworthiness						
Ba1	*BB+*	*BB+*		350%	150%	100%
Ba2	*BB*	*BB*	*Low grade, speculative*			
Ba3	*BB-*	*BB-*				
B1	*B+*	*B+*		Deducted from Capital (same applies when unrated)		
B2	*B*	*B*	*Highly speculative*			
B3	*B-*	*B-*				
Predominantly Speculative – Substantial Risk or in Default						
	CCC+					150%
Caa	*CCC*	*CCC*	*Substantial risk, in poor standing*			
	CCC-					
Ca	*CC*	*CC*	*May be in default, extremely speculative*			
C	*C*	*C*	*Even more speculative than those above*			
	CI		*CI = Income bonds – no interest is being paid*		Deducted from Capital	Deducted from Capital[33]
		DDD	*Default*			
		DD				
	D	*D*				

[27] Frank J. Fabozzi, "The Handbook of Fixed Income Securities, sixth edition," Chapter 11, (New York: Irwin Professional Pub. 2000), 273.

28 For further details cf. Karin Reichardt-Petry, Basel II: "Vom Kredit über die kreditrisikomindernden Techniken bis zur Verbriefung," in: Praktiker Handbuch Asset-Backed-Securities und Kreditderivate, Strukturen, Preisbildung, Anwendungsmöglichkeiten, aufsichtsrechtliche Behandlung, eds. Josef Gruber, Walter Gruber and Hendryk Braun, (Stuttgart: Schäffer-Poeschel Verlag, 2005), 349 (377).

[29] Basel II, Part 2, IV, nr. 3 standardized approach for securitization exposures.

[30] Basel II, Part 2, II, nr. 6.

[31] Information on sovereign risk and on securitized instruments is taken from Dimitris Chorafas, "Managing Credit Risk, analysing, rating and pricing the probability of default," vol. I, (London 2000,) 93.

[32] For the short term a different Moody-scale applies.

[33] It makes little sense to risk-weigh a partially defaulted loan. In any case of default, the amount of the outstanding loan should therefore be deducted from capital for risk-measuring purposes. Basel II in Part II, A, 1 only states that claims on sovereigns and their central banks will be risk-weighted 150% if rated below B-. Logically, it does not make sense, however, to risk-weigh a partially defaulted loan. Therefore, assuming the interpretation of Basel II follows ordinary rules of interpretation, for partially defaulted loans the nominal value of the loan should be deducted for risk-measurement purposes.

In recent years, both S&P and Moody's have supplemented their credit risk assessment with "credit watches" and "rating outlooks" designed to indicate their perspectives on future developments that might justify a rating change.[34] Kräussl has identified a slight, but nevertheless noteworthy, distinction between "credit watches" and "rating outlooks." Credit watches are part of the formal committee-based process by which the agencies' ratings are assigned. Mere "outlooks," however, are not based on the formal review process and, thus, carry less authority. The myriad of rating qualifications exists as a world of its own, which requires expertise in order to fully understand the meaning and importance of a rating.

Ratings do not, however, contain a recommendation to buy. For example, it might be worthwhile to buy a CC-rated bond at a proper discount. On the other hand, an AAA-rated security might have little economic value. In Germany, where most corporate financing is still provided via bank-mediated loans rather than directly from the capital markets, the banking industry has agreed upon a common general standard to achieve greater comparability within internal rating systems. IFD has set the following standards:

The IFD rating scale:[35]

> "The members of the IFD have agreed on a six step rating scale. They promise to disclose to their customers their rating decision and to translate it to this IFD scale. The IFD members thereby achieve transparency in the rating process and facilitate an objective discussion on the rating decision…"

[34] Roman Kräussl, "Sovereign Risk, Credit Ratings and the recent financial crises in Emerging Markets, Empirical Analysis and Policy Implications," *Schriftenreihe des Center for Financial Studies an der Johann Wolfgange Goethe-Universität Frankfurt am Main, Monographien XVIII,* (Frankfurt am Main 2003), 30.

[35] http://www.initiative-finanzstandort.de/download/IFD_Ratingskala.pdf.

Figure 4: The IFD rating scale

Rating step	*Description*	*Range of default probability*
I	*Company with creditworthiness ranging from very good to good standard*	*Up to 0.3%*
II	*Good to satisfactory creditworthiness*	*0.3 to 0.7%*
III	*Satisfactory creditworthiness*	*0.7 to 1.5%*
IV	*Above average to increased risk*	*1.5% to 3%*
V	*High risk*	*3-8%*
VI	*Very high risk*	*From 8%*

The probability of default (=PD) indicates how likely it is that a debtor defaults within one year (usually in formal insolvency proceedings).
It should be noted that:

> First, the indicated PD-boundaries do not correspond exactly to the PD-boundaries of the given rating classes at the individual institutions. Theoretically, it may happen that even when exactly the same PD-estimates are awarded, two institutions may classify under different IFD classes (for example, PD of 1.37 results in a rating of BB- and therefore an IFD rating grade IV, whereas strictly adhering to the PD-area would imply a rating grade III classification).
> Second, the institutions use differing default definitions, which may lead to distortions (for example, comparing US-GAAP with. *HGB*[36] is indeed problematic)."

Similar efforts to increase the comparability of internal ratings have been made by the German savings banks. The Federation of German Savings Banks, DSGV (*Deutscher Sparkassen und Giroverband*) has a rating scale with 18 different rating standards.[37] 50% of the DSGV standard is composed of "soft

[36] *HGB* = Handelsgesetzbuch, the German commercial code. It contains detailed principle-based accounting rules that are still in use for non-consolidated balance sheets.

[37] Thomas Steinmeyer, "Rahmenbedingungen und Ziele für den Kreditrisikohandel mit Sparkassen," in: *Praktiker Handbuch Asset-Backed-Securities und Kreditderivate, Strukturen,*

factors," yet whether this initiative by the savings banks is successful remains to be seen.

The German Institute for Standard Setting has also proposed standards to allow for greater comparability (*DIN ISO 9000* ff.) in the credit business.[38] Given the prevalence of medium-sized companies in Germany, these initiatives may prove to be valid alternatives to costly external ratings.

Whatever the grading scheme for ratings involved, if the rating is to be of any value to the issuer and the general public, it should communicate the standard clearly. One of the benefits of percentage grades like those proposed by the IFD is that they account for objectively comparable units. US businesses, or law schools, for example, rely widely on percentage rankings to assess and select their international student base. A mere translation of grades obtained at non-US schools is meaningless to admission officers. The same is true for rating assessments. While the experienced investor is familiar with the scale used by Moody's, S&P and Fitch's, the correlation with absolute numbers still requires experience that a lay investor does not have.

Absolute correlations like the one proposed by the IFD should, therefore, be supported. If the IFD initiative is successful, external ratings for medium-sized companies who tap only the German capital markets[39] may become obsolete in certain cases.

Preisbildung, Anwendungsmöglichkeiten, aufsichtsrechtliche Behandlung, eds. Josef Gruber, Walter Gruber and Hendryk Braun, (Stuttgart: Schäffel-Poeschel Verlag, 2005), 285 (289).

[38] Hans H. Friedl, "Neue Anforderungen an die Bonitätsanalyse im Firmenkundengeschäft," in *Die Banken auf dem Weg ins 21. Jahrhundert, Strategien und Konzepte, International Bankers Forum* e.V., (Wiesbaden: Gabler Verlag 1996), 133-151 (145).

[39] On the development of the German capital markets and the rates of return of the various industries, cf. Annerose Engelhardt, Marshall Sarnat, "The Pattern of Risk and Return in Germany, Selected Industries, 1928-1976," discussion paper series, International Institute of Management, Berlin 1978.

Naturally, external rating agencies also have mathematical default rates in mind when deciding on a rating, but they do not declare a mathematical correlation between default rates and their prognostics. Moody's, for example, offers numbers from past ratings and default probabilities for the period from January 1, 1993 to January 1, 1996 that show a clear correlation between the rating assigned and the default statistics of the issuer actually obtained.

Moody's letter ratings and marginal default rates show a certain degree of coherence between the ratings assigned and the risk of default.[40] This reliability has lead to research that attempts to deduce the market-implied rating from market observations.[41]

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[40] Countries: Argentina, Aruba, Australia, Austria, Bahamas, Bahamas - Off Shore, Bahrain - Off Shore, Barbados, Belgium, Belize, Bermuda, Bolivia, Brazil, British Virgin Islands, Bulgaria, Canada, Cayman Islands, Cayman Islands - Off Shore, Channel Islands, Chile, China, Colombia, Costa Rica, Croatia, Cyprus, Czech Republic, Denmark, Dominican Republic, Ecuador, Egypt, El Salvador, Estonia, Fiji, Finland, France, Germany, Greece, Guatemala, Guernsey, Honduras, Hong Kong, Hungary, Iceland, India, Indonesia, Iran, Ireland, Isle of Man, Israel, Italy, Jamaica, Japan, Jersey, Jordan, Kazakhstan, Korea, Kuwait, Latvia, Lebanon, Liberia, Liechtenstein, Lithuania, Luxembourg, Malaysia, Malta, Mauritius, Mexico, Micronesia, Moldova, Morocco, Netherlands, Netherlands Antilles, New Zealand, Nicaragua, Norway, Oman, Pakistan, Panama, Paraguay, Peru, Philippines, Poland, Portugal, Puerto Rico, Qatar, Romania, Russia, Saudi Arabia, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Taiwan, Thailand, Trinidad & Tobago, Tunisia, Turkey, Ukraine, United Arab Emirates, United Kingdom, United States, Uruguay, Venezuela.
Industries: M12-Banking, M12-Consumer Products, M12-Energy, M12-Financial (Non-Bank), M12-Hotel, Gaming, & Leisure, M12-Industrial, M12-Media, M12-Miscellaneous, M12-Retail, M12-Sovereign, M12-Technology, M12-Transportation, M12-Utilities
Report Definition Last Updated : 8/18/2004;
http://www.moodys.com/cust/crc/crcDefaultRateReport.asp?busLineID=400000000078&reportID=-1&ratingType=Letter&subReport=Marginal

[41] Cf., for example, "Market Implied Ratings, A simple approach to improve the classification of bonds and produce superior risk forecasts,"
http://www.barra.com/support/library/credit/market_implied_ratings.pdf.

Figure 5: Moody's historic ratings and marginal default rates

Weighted Average Letter Rating
Marginal Default Rates

Ratings	Year 1	Year 2	Year 3	Year 4
Aaa	0.00%	0.00%	0.00%	0.00%
Aa	0.00%	0.00%	0.00%	0.00%
A	0.00%	0.00%	0.00%	0.00%
Baa	0.00%	0.07%	0.11%	0.00%
Ba	0.35%	0.62%	1.08%	0.76%
B	3.63%	3.99%	4.52%	2.16%
Caa-C	13.02%	7.82%	14.29%	14.29%
Investment - Grade	0.00%	0.02%	0.03%	0.00%
Speculative - Grade	2.51%	2.32%	2.77%	1.47%
All Corporations	0.72%	0.63%	0.68%	0.31%

Similar figures are reported by S&P:

Figure 6: S&P Cumulative Average Default Rates (table format)[42]

S&P

Cumulative Average Default Rates by Rating Modifier 1981 to 2004 (%)

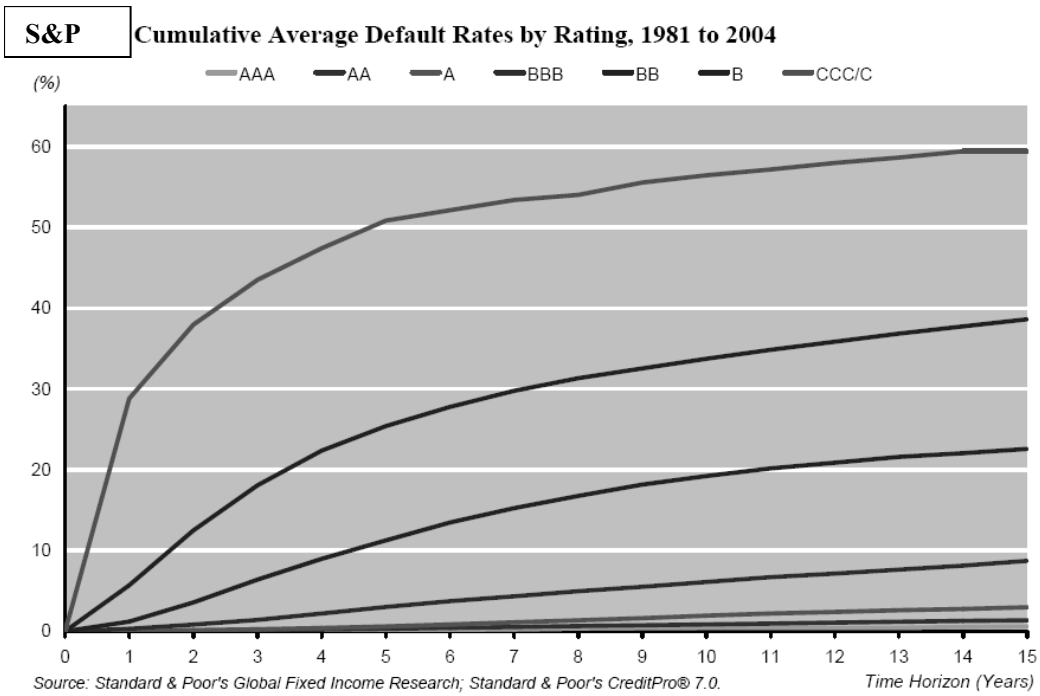
	Time horizon														
Rating	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10	Y11	Y12	Y13	Y14	Y15
AAA	0.00	0.00	0.03	0.06	0.10	0.17	0.24	0.36	0.41	0.45	0.45	0.45	0.45	0.53	0.61
AA+	0.00	0.00	0.00	0.08	0.16	0.25	0.34	0.34	0.34	0.34	0.34	0.34	0.34	0.34	0.34
AA	0.00	0.00	0.00	0.07	0.15	0.23	0.35	0.50	0.63	0.77	0.88	0.96	1.13	1.22	1.28
AA-	0.02	0.10	0.23	0.36	0.52	0.68	0.83	0.91	1.00	1.11	1.23	1.43	1.52	1.71	1.82
A+	0.05	0.11	0.27	0.48	0.64	0.82	1.02	1.20	1.45	1.68	1.95	2.25	2.53	2.84	3.12
A	0.04	0.12	0.17	0.25	0.42	0.65	0.87	1.13	1.41	1.80	2.12	2.29	2.49	2.56	2.79
A-	0.04	0.16	0.32	0.54	0.86	1.18	1.61	1.87	2.20	2.44	2.55	2.73	2.79	2.95	3.12
BBB+	0.22	0.63	1.21	1.72	2.30	2.90	3.36	3.76	4.25	4.65	5.03	5.32	5.80	6.42	7.23
BBB	0.28	0.62	0.91	1.52	2.17	2.76	3.31	4.01	4.58	5.27	6.04	6.52	7.05	7.24	7.67
BBB-	0.39	1.28	2.29	3.65	4.94	6.08	6.93	7.69	8.25	8.97	9.53	10.17	10.59	11.42	12.10
BB+	0.56	1.68	3.57	5.15	6.47	7.84	9.25	9.84	10.88	11.74	12.35	12.90	13.37	13.89	14.85
BB	0.95	2.99	5.47	7.78	9.98	12.19	13.84	15.31	16.51	17.34	18.26	18.99	19.40	19.52	19.52
BB-	1.76	5.16	8.78	12.14	15.03	17.75	19.82	21.87	23.65	24.97	26.17	26.93	28.02	28.76	29.49
B+	3.01	8.40	13.46	17.79	20.86	23.15	25.34	27.16	28.63	30.15	31.45	32.61	33.77	34.92	35.88
B	8.34	16.68	22.60	26.60	29.44	31.88	33.36	34.44	35.40	36.29	37.27	38.32	39.34	40.11	41.07
B-	12.15	22.09	29.64	34.35	37.71	40.31	42.52	43.88	44.52	45.05	45.44	45.65	45.88	46.12	46.39
CCC/C	28.83	37.97	43.52	47.44	50.85	52.13	53.39	54.05	55.56	56.45	57.20	57.99	58.66	59.44	59.44
Investment Grade	0.11	0.31	0.55	0.86	1.20	1.53	1.84	2.13	2.41	2.71	2.99	3.21	3.44	3.65	3.92
Speculative Grade	4.91	9.76	14.05	17.52	20.22	22.46	24.32	25.80	27.13	28.25	29.28	30.15	31.01	31.74	32.42
All Rated	1.64	3.29	4.78	6.04	7.08	7.97	8.71	9.34	9.92	10.45	10.94	11.35	11.75	12.12	12.51

Source: Standard & Poor's Global Fixed Income Research; Standard & Poor's CreditPro® 7.0.

[42] S&P accompanies these figues with the following information on the scope of its statistical population: "Issuers included in this Study. The study analyzed the rating histories of 11,150 companies that were rated by S&P as of Dec. 31, 1980, or that were first rated between that date and Dec. 31, 2004. These companies include industrials, utilities, financial institutions, and insurance companies around the world with long-term local currency ratings. The analysis excludes public information ("PI") ratings and ratings based on the guarantee of another company. Structured finance vehicles, public-sector issuers, and sovereign issuers are the subject of separate default and transition studies and are also excluded from this study."

This data translates into almost ideal graphs of cumulative default rates by rating category:

Figure 7: S&P Cumulative Average Default Rates (graphical illustration)



The evident consistency between default rates and ratings is, however, not necessarily as revealing as they seem to be. Some research suggests, at least for certain periods, that rating agencies have lagged behind the capital markets considerably.[43] If ratings are adapted often enough, this will, of course, not show in the statistics, but would, however, indicate that ratings have little prognostic value. That again would support the argument that rating agencies sell li-

[43] Frank Partnoy, "The Siskel and Ebert of Financial Markets? Two Thumbs down for the Credit Rating Agencies," *Washington University Law Quarterly,* vol. 77, no. 3, (1999), 620-711 (647).

censes (ratings) only to do business in the capital markets, but that the informational value of the ratings is low.

Most institutional issuers, either by law or under their own rules, may only invest in investment graded securities. While individual investors may – in theory – freely invest in all types of securities, most of the time they lack the expertise required to invest in speculative bonds. They should and do abstain from such investments. These criteria apply to bonds but are similarly applicable to the issuance of preferred stock.[44]

2.4. Securitization

Securitizations without ratings are are unthinkable. This is no coincidence. There are at least two reasons why securitizations present greater information asymmetries to be remedied with ratings than ordinary issuances:

1. Securitized assets are generally sold to the investors through a special purpose entity with no track record and no other assets supporting the issuance but for its underlyings. Simple bond issuances by corporate institutions or public authorities raise far fewer questions with respect to asymmetric information than do securitizations. In a simple straightforward bond issuance by a corporation, the investors have an idea of the risk profile of the corporation and can claim recourse on the corporation's assets.

   In securitizations, however, there is typically no recourse against or from the "originator," and the formal seller of the securities is a company established for this particular purpose. This independence from the

[44] Frank J. Fabozzi, *The Handbook of Fixed Income Securities, sixth edition*, chapter 15, (New York: Irwin Professional Pub. 2000), 341.

originator functions both ways; there is no recourse to the issuer, but there should also be no recourse from (the creditors of) the originator. This latter characteristic is called "bankruptcy remoteness"[45] or "insulation from the risks of insolvency" of the originator and is achieved through a "true sale" between the issuer and the issuer (so-called true sale securitization).

2. Securitizations – although being standardized – are one-time events, whereas other issuances (corporate bonds, government bonds) generally affect repeat players. Repeat players have less incentive to cheat than "one-time issuers." This has already been observed by Adam Smith[46]:

> "When people seldom deal with one another, we find they are somewhat disposed to cheat because they can gain more by a smart trick than they can lose by the injury which it does their character."

[45] Petrina R. Dawson, "Ratings Games with Contingent Transfer: A Structured Finance Illusion," *Duke Journal of Comparative and International Law* 381 (1997-1998), 383.
[46] Cf. Adam Smith in a 1763 lecture, "Of the Influence of Commerce on Manners":
"Of all the nations in Europe, the Dutch, the most commercial, are the most faithful to their word. The English are more so than the Scotts, but greatly inferior to the Dutch… This is not at all to be imputed to the national character, as some pretend; there is no natural reason why an Englishman or a Scott should not be as punctual in performing agreements as a Dutchman. It is far more reducible to self-interest, … which is as deeply implanted in an Englishman as in a Dutchman. A dealer is afraid of losing his character, and is scrupulous in observing every engagement. When a person makes perhaps twenty contracts a day, he cannot gain so much by endeavoring to impose on his neighbours, as the very appearance of a cheat would make him lose. When people seldom deal with one another, we find they are somewhat disposed to cheat, because they can gain more by a smart trick than they can lose by the injury which it does their character."
Cited from Frank Partnoy, "The Siskel and Ebert of Financial Markets? Two Thumbs down for the Credit Rating Agencies," *Washington University Law Quarterly,* vol. 77, no. 3, (1999,) 620-711 (628, footnote 31).

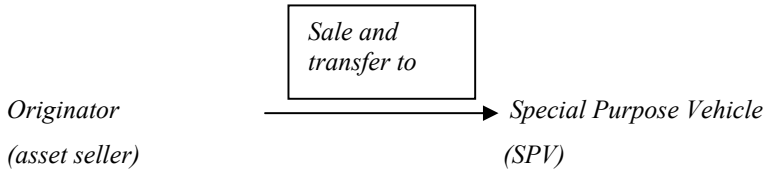
Rational investors know this and account for the incentive to cheat by a discount on the otherwise appropriate price. The discount of securitizations can be minimized or avoided through ratings.

Nowadays, some firms have specialized in securitizations thus investing their reputational capital as repeat players in the market[47] and thereby slightly reducing the one-time discount.

The basic structure is complex and each securitization, although in practice often reliant on the standard business practices as developed by organizations like International Swaps and Derivatives Association, Inc., ISDA, nevertheless requires some adaptations with respect to its underlyings and the jurisdictions at stake.

The main structure resembles the one used for project finance operations and takes the form[48] of a portfolio of claims from an originator which is sold and transferred to a special purpose vehicle, SPV, which is a corporate entity created for the limited purpose of acquiring and financing specific assets (Basel II refers to a special purpose *entity*).

Figure 8: Typical contractual relations in an ABS transaction

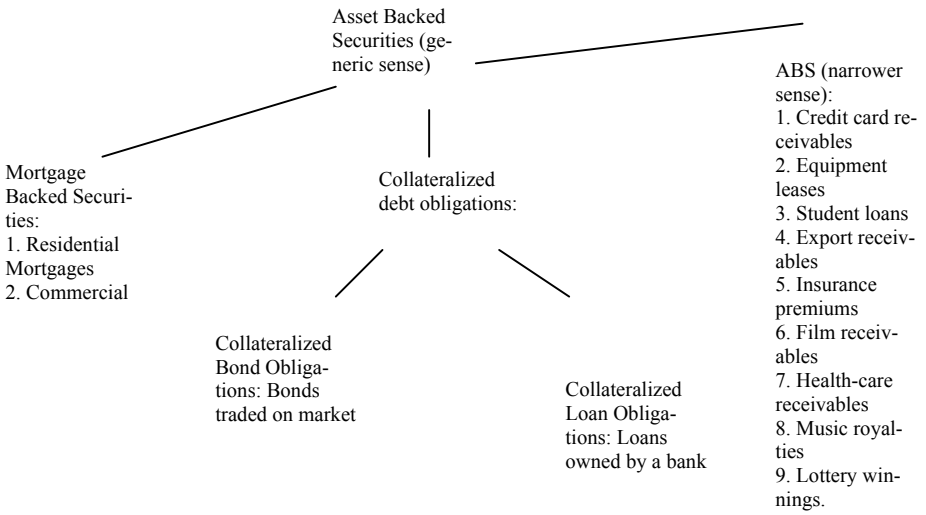


[47] For example, the Swiss-based Capital Efficiency Group has specialized on setting up Mittelstand mezzanine financing structures.

[48] The following three paragraphs as well as the table with the structure were inspired to a great extent by the succinctly written paper from Hendryk Braun, "Klassifizierung von Asset-Backed-Securities," in: *Praktiker Handbuch Asset-Backed-Securities und Kreditderivate, Strukturen, Preisbildung, Anwendungsmöglichkeiten, aufsichtliche Behandlung*, eds. Josef Gruber, Walter Gruber and Hendryk Braun, (Stuttgart: Schäffel-Poeschel Verlag, 2005), 61 (64).

Typically the assets sold are receivables; for example, the originator is a bank, has various debtors and is secured by mortgages. The result of the securitization will, therefore, be called "mortgage-backed securities." If the assets involved, termed the "underlying," comprise assets secured by other forms of collateral, the resulting securities are referred to as "asset-backed securities." In the case of asset-backed securities where the underlying claim is a bank-loan, industry jargon speaks of "collateralized loan obligations" (CLOs), and when the underlying claim is a bond, the relevant term is "collateralized bond obligations (CBOs). "Asset-backed securities" is, however, also the generic term for both mortgage and asset-backed securities.[49]

Figure 9: Terminology of securitizations[50]



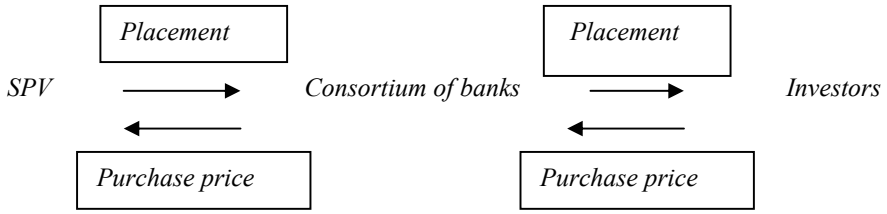
[49] Andreas A. Jobst, "Collateralised Loan Obligations (CLOs) – A Primer, Accounting for Financial Instruments in the Banking Industry," no. 96, ISSN 1434-3401, (Frankfurt/Main, December 2002), 3.

[50] This diagram is taken from Andreas A. Jobst, "Collateralised Loan Obligations (CLOs) – A Primer, Accounting for Financial Instruments in the Banking Industry," No. 96, ISSN 1434-3401, (Frankfurt am Main, December 2002), 5.

Naturally, an SPV that has been established solely for the purpose of securitizing assets at a later date has, so far, no liquidity with which to pay the purchase price; thus, the originator will usually resell his claim against the SPV to a bank in order to receive the (discounted) purchase price as immediate cash. This first part of the process is called the "basic transaction."

The SPV then[51] turns to a consortium of (investment) banks that will sign some form of underwriting agreement to take on the newly issued securities. The structure hereby followed is customary for a "one-tier transaction." In a two-tier transaction, the SPV would only function as an intermediary and turn to a second SPV, which would then be the issuer of the underlying claim between the two SPVs (which may constitute a pledge or a sale).[52] There are two forms of underwriting: soft and firm. In soft underwriting, the investment bank does not guarantee to pay a certain price, but only offers the placement process on a "best effort" basis. In the case of firm underwriting, the investment bank consortium (organized by a "lead underwriter") does, however, give some guarantee with respect to either price, quantity, or both.

Figure 10: Typical contractual relations in an ABS transaction



[51] The division of this process into various steps is for explanatory purposes; in practice, contracts are made dependant on each other by conditions precedent and made effective *uno actu.*

[52] Cf. Petrina R. Dawson, "Ratings Games with Contingent Transfer: A Structured Finance Illusion," *Duke Journal of Comparative and International Law* 381 (1997-1998), 387.

Typically, the securities issued will be bonds. The SPV will usually also have a contract with a bank for credit enhancement (minimum guarantee) and for liquidity support (in case the underlying assets do not provide for a steady cash flow). The SPV will then pay the originator (or, if the claim was sold to a financing agent, then this agent) with the return on the sale of securities.

The securities issued by the SPV will be divided into "tranches." If the securitization is geared towards capital markets, a rating by an external rating agency becomes necessary and placement of the securities will be achieved through a consortium, which may or may not promise to take on the placement risk for a fee or may merely promise to procure placement without taking such legal risk ("firm underwriting"). Both One provider may supply many functions, but economically each function is different and requires a distinct fee. In addition, unless a particular type of tort liability is attached, the investors have contractual relations with the special purpose vehicle only and no means of recourse against the originator.

Each tranche will be assigned a rating corresponding to its risk structure (senior reaching AAA rating, mezzanine A, subordinated BB and "equity-graded" B rating). Typically, a servicing agent is also mandated by the SPV to administer the current management and the enforcement and servicing of claims. In practice, it is then the originator who usually performs this function.

The structuring of securitizations is completed by the arranger who is responsible for the evaluation of the portfolio of claims. Also, fixed incoming payments to the SPV are typically converted (through a swap agreement) into variable payments thus preventing changes to interest rate risk from the bonds (Libor/Euribor plus spread). As part of the structure, some of the risks (currency risks or liquidity shortages for example) are absorbed by the security provider. A trustee will be interposed between the investors and the issuer and will be in

charge of controlling the regularity of the transaction. The trustee may also be interposed as a payment transferor between investors and the servicer.

This description of securitization applies to true-sale securitization; a synthetic securitization is more complex. In a synthetic securitization, no transfer of securities takes place. However, through an array of contracts, economically speaking, the same result is achieved as in a true sale securitization. The synthetic type of securitization is problematic, in particular for banks, which try continuously to ameliorate their accounting and regulatory capital position ("get the assets off the books"). Generally, this is not achieved in a synthetic securitization. Nevertheless, a synthetic securitization might be warranted in order to avoid the confidentiality issues described earlier on.

An advantage of true-sale securitization (over the synthetic type) is that the credit risk of the issuance vehicle can be shielded from the credit risk of the originator ("insolvency remoteness"). There are generally six criteria for bankruptcy remoteness, summarized by Dawson as follows[53]:

- "First, so long as the rated securities are outstanding, the entity should be prohibited from engaging in a merger, consolidation, or asset transfer with an entity not rated at least as high as the rated securities, or that lacks bankruptcy-remote special-purpose criteria.
- Second, the entity should be restricted from incurring additional debt. In the alternative, the entity's organizational documents should prohibit the incurring of additional debt other than debt rated at least as high as the rating on the issue in question, or debt that (a) is fully subordinated to the rated debt, (b) is non-recourse to the issuer or any assets of the issuer other than cash flow in excess of amounts

[53] Petrina R. Dawson, "Ratings Games with Contingent Transfer: A Structured Finance Illusion," *Duke Journal of Comparative and International Law* 381 (1997-1998), 392.

necessary to pay the issuer to the extent that funds are insufficient to pay such additional debt.

- Third, the entity should not engage in any other business or activity.
- Fourth, the entity should have at least one "independent director" on the board of directors, and the consent of that director should be required to institute insolvency proceedings.
- Fifth, the transaction documents should contain a covenant preventing the parties from filing, instigating or joining in any involuntary bankruptcy proceeding against the entity so long as the rated securities are outstanding.
- And finally, the entity should also agree to abide by certain "separateness covenants" ...[54]

Thus, a better price may be reached. Consider an issuer in the industrial segment with a relatively low equity ratio. A securitized sale of the assets from such a company to the capital markets would have to account for the credit risk associated with such a company; however, in a true sale securitization through an issuer vehicle, ratings and the general risk assessment are based solely on the

[54] "...whereby the entity promises the following:

(a) to maintian books and records separate from any other person or entity;
(b) not to combine assets with those of any other entity;
(c) to conduct its business in its own name;
(d) to maintian separate financial statements;
(e) to pay its liabilities out of its own funds;
(f) to observe all corporate formalities;
(g) to maintian an arm's length with its own employees;
(i) not to guarantee or become obligated for the debts of any other entity or hold out its credit as being available to satisfy the obligations of others;
(j) to allocate fairly and reasonably any overhead for shared office space;
(k) to use separate stationery, invoices, and checks;
(l) not to pledge its assets for the benefit of any other entity; and
(m) to hold itself out as a separate entity."

value of the underlying with no respect to the credit risk of the originator. Thus, the "insulation" of the credit risk may lead to an increase in the issuance price and thereby be indirectly transferred to the originating entity.

In theory, this mechanism should make securitization via true sale particularly profitable as a means of financial restructuring in the area of non-performing loans. The German capital market has developed sufficient broadness to allow for such non-performing loan securitizations as well as other types of securitizations.[55] Typically, common law jurisdictions are sought for securitizations even of underlyings stemming from civil law jurisdictions. Thus, in practice, securitizations also have to take into account the effects of national and international tax law. Dawson argues that "the evaluation of securitizations may differ in civil law and common law jurisdictions":[56]

> "Because of the formality of the civil codes, the inability to rely on equitable principles, and the scarcity or uncertainty of precedent to define the law, civil law jurisdictions pose special problems for securitizations."[57]

While I concur with the observation that securitizations are typically completed using Anglo-Saxon jurisdictions as issuer-country jurisdiction, the argument that this is due to simple formality is not convincing. Under German trade tax law (section 9 nr. 1 GewStG), interest from long-term loans is only

[55] Peter Köhler, "Deutsche Verbriefungsinitiative TSI verfehlt ihre Ziele für 2005, Prestigeprojekt der Banken wird jetzt auf faule Kredite ausgedehnt," Handelsblatt, July 29, 2005, 19 with a report on the performance of the "true sale initiative" (TSI) organized by the "True Sale International GmbH" and funded by German banks. www.true-sale-international.de
[56] Petrina R. Dawson, "Ratings Games with Contingent Transfer: A Structured Finance Illusion," *Duke Journal of Comparative and International Law* 381 (1997-1998), 384.
[57] Petrina R. Dawson, "Ratings Games with Contingent Transfer: A Structured Finance Illusion," *Duke Journal of Comparative and International Law* 381 (1997-1998), 384.

partially deductible from profits (50%). There are exceptions for credit institutions and for entities that are active solely in the issuance of bonds (section 19 GewStDVO, trade tax ordinance). This exception has, however, not been tested in the courts, and while its application to securitization special purpose vehicles seems likely, the remaining risk of interest non-deductibility is sufficient to drive issuer vehicles off-shore. Also, jurisdictions like Ireland, the UK and the Channel Islands have developed exceptionally flexible corporate law allowing for the special purpose vehicle's corporate objective to be restricted effectively. For example, the articles of association of a special purpose vehicle will typically allow it to have very few employees of its own and may restrict its investment decisions further still (by way of the trustee relationship). Thus, investors in the bonds of such SPV do not have to account for any business risk at the level of the SPV and may focus their analysis solely on the underlyings. Corporate law in many civil law jurisdictions is not quite so flexible in this respect. For example, there is no *ultra vires* doctrine under German law and thus, a corporate restriction as to the corporate entity's purpose would not effectively restrict the ambit of corporate actions to the same extent as in a common law jurisdiction.[58]

The reasons for the reticence towards true-sale securitizations thus lay, at least in the German case, in the inflexibility of corporate law, German tax law, the risk of non-deductibility of interest payments, and the importance of confidentiality concepts under German banking law (cf. 2.2. Confidentiality issues in securitizations).

[58] German corporate law would only sanction the evident or collusive "abuse of power" (*Mißbrauch der Vertretungsmacht*) with third parties. The intent of the German law in this respect is to protect third parties from relying on director's powers. Thus, although this is customary for transactions with Anglo-Saxon parties involved, under German law it would, in principle, not be necessary to review the corporate statutes to establish directors' power of representation.

Due to the industry's acceptance of Anglo-Saxon jurisdictions as issuer entity law, one should also bear in mind that a financial industry has developed (particularly in Ireland, the UK and the Channel Islands) with corporate administrators readily available to provide the legal infrastructure to administer the SPVs on a daily basis. That, however, poses a problem under international tax law with the "base-company concept." The result is that in every instance, the practical administration of the SPV must be coordinated so as to create an entity stable enough to invoke residency status for the application of double tax treaties, should that be necessary for the tax efficient structure of international payment streams from underlyings in other (particularly in civil law) jurisdictions.

In asset-backed securities[59] the underlyings are made transferable through a complex structure typically involving an SPV as the issuer. For example, if a bank has a portfolio of outstanding credit card loans, it could securitize these assets by founding an SPV, bringing the loans in to the SPV as capital, and letting the SPV sell newly issued securities (typically bonds) with the loans as underlying. The bank itself would receive the purchase price from the SPV, with the cash generated by the sale of securities. Under Basel II and the general target of diversification, this operation makes complete sense for the bank. It gets the already (potentially) non-performing loans off its books and can focus on its business strength of acquiring new debtors as clients. Espe-

[59] The term asset-backed securities is defined in a circular published by the "Bundesanstalt für Finanzdienstleistungsaufsicht." Circular on "the sale of claims on clients in the context of asset-backed securities transactions through German credit institutions" from March 19th 1997 (circular 4/97)[translated]: "The term "asset-backed securities" (ABS) refers to stocks or bonds that represent claims against a specially established company (special purpose vehicle) for the ABS-transaction. The claims will be backed by a portfolio of unsecuritized claims (assets), which are transferred to the special purpose vehicle and which primarily serve the holders of the asset-backed securities (investors) as security."

cially for regional banks or banks with a specialized customer-base, the need to diversify may be particularly pronounced.

Frequently, loans secured by mortgages on real estate serve as the underlying to these transactions known as MBS (mortgage-backed securities). Two types of MBS may be differentiated:

1. Residential Mortgage-Backed Securities (RMBS),[60]
2. Commercial Mortgage-Backed Securities (CMBS).

The two types of MBS exhibit very different risk profiles. For RMBS, the income status of the debtors is decisive for the value of the asset-backed securities, whereas for CMBS it is primarily the valuation of the objects involved that is determinative. Securitization is a technique that may be employed for all types of underlying assets:

1. Consumer loans
2. Leasing contracts
3. Performance or servicing agreements
4. Automobile financing agreements
5. Student loans
6. Licensing agreements, etc.

In certain cases, particularly with respect to foreign investors who would otherwise face too many transaction costs when accessing local markets, ABS is a convenient way to participate in a potential increase in value of the underly-

[60] For the problems relating to confidentiality issues, please refer to the section on confidentiality.

ing. Non-performing loans have become an important asset class for securitizations since the banking and real estate crisis in the US in the 80ies (savings and loan crisis). Since most banks had similar problems, from the beginning, Hedge funds were the most prospective buyers. The current performance problems[61] in the German banking sector will in all likelihood also be resolved in a similar fashion by resorting to investors like the fund company Lone Star. In autumn 2003, for example, Hypo Real Estate sold loans to Lone Star and JP Morgan in the total amount of € 480 million.[62]

In the German banking market the current rush to ABS-financing is also heavily driven by the public banking sector, which lost state guarantees at the end of 2005. [63] The intention behind the EU Commission's insistence that the public banks lose such state guarantees aimed to establish a level-playing field between state and privately run banks.[64]

In these recent transactions involving non-performing loans, the indirect buyers of distressed loans may have counted on the enforcement of collateral for obtaining access to the real estate market. This is probably true for many UK or US-based investment funds and investment banks that lately have invested heavily in non-performing loans of German origin.

From the point of view of the originator, securitization is a convenient way to enhance its liquidity. This is especially true for municipalities with bu-

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[61] Although the four large private banks in Germany (Deutsche, Dresdner, Commerzbank, HypoVereinsBank) have granted 25% fewer loans from 2001-2003, the return on equity was only -5%.

[62] Jens Rinze and Klaudius Heda, "Non-performing loan und Verbriefungs-Transaktionen: Bankgeheimnis, Datenschutz," § 203 StGB und Abtretung, Wertpapiermitteilungen 2004, 1557.

[63] Jens Rinze and Klaudius Heda, "Non-performing loan und Verbriefungs-Transaktionen: Bankgeheimnis, Datenschutz," § 203 StGB und Abtretung," Wertpapiermitteilungen 2004, 1557.

[64] On the history of state interventions in the field of banking, cf. Dimitris Chorafas, "Managing Credit Risk, The lessons of VaR failures and imprudent exposure," vol. II, (London: Euromoney Books 2000), 220-224 (in particular 222).

reaucratic claim enforcement structures. Therefore, securitization should also be expected in areas such as unpaid traffic fines etc. Although the discounting of claims, especially with respect to checks and letters of credit, is a field in which banks should, in principle, be the dominant players, in securitization new funding methods and techniques have frequently attracted very different players. Besides investment banks, many hedge funds play a substantial role as investors in such transactions.

Also, from the point of view of the originator, securitization is a means by which to achieve greater diversification of assets, to specialize in origination and to find investors for financial products that would not otherwise attract any interest. It may also lead to a decrease in borrowing costs. According to Basel II, un-rated securities should be valued at a 100%[65] and a rating for securitized instruments of A+ or better should reduce the amount of capital to be withheld by a bank wishing to invest in the instrument. Since it often happens that part of the securitized instruments are purchased by the originator itself and the originator is a credit institution, the securitization of highly rated securities reduces the amount of a capital to be withheld by such institutions.

Consider, for example, a small German savings bank with access to a small client base. If the bank wanted to comply with Basel II, it would have to stop originating new loans (assets from the point of view of the bank) even though origination is its main business focus and it would have difficulty finding a different investor base. Therefore, it may be expected that greater use of securitization will not only enable originators to diversify their asset base, but will also allow for greater specialization in the financial markets.

[65] Dimitris Chorafas, "Managing Credit Risk, Analysing, rating and pricing the probability of default," vol. I, (London: Euromoney Books, 2000), 93.

Typically, the sums involved in securitizations are so substantial that the transaction costs per unit are relatively lower than they would have been, were the underlyings to be sold unit per unit.

The technique of "securitization" will probably also be used in the future German market for Real Estate Investment Trusts (REITs). Again, the ratings of such issuances will come under the scrutiny of (external) rating agencies.[66]

Almost always, the securities sold by such a SPV are sold as slices to the market. The securities are subdivided into layers called "tranches." Typically, there are at least three tranches: a senior tranche rated highly, a junior tranche, and a first loss piece.

For example, the first 80% of the nominal value of the loans being repaid are classified as tier one security and rated AAA. Typically, there would be a layer rated A (medium) and one having a speculative grade. Since many institutional investors may only invest in certain classes of securities, this process allows such investors to choose a form of security suitable to their requirements. Hedge funds might also find added value in differentiating between the various layers to achieve arbitrage effects, e.g. by buying tier three securities short and by having a long position on tier one securities.

The top-rated tranche might obtain a higher price when selling through a SPV rather than through the originator. In particular, if the mechanism involves credit elements and the originator itself has a bad rating, then this rating will weigh heavily on the purchase price. Setting up a securitization technique might enable the originator to sell the underlyings at a premium when compared to the

[66] In other countries these types of investments already exist. The emergence of REITs is seen in the wider context of the growing importance of capital markets as a means to increasing fungibility, flexibility and diversification, "Die Banken setzten auf Immobilienaktien, Trotz des gescheiterten Gesetzentwurfs sollen Immobilien börsenfähig gemacht werden," *Frankfurter Allgemeine Zeitung,* July 1, 2005, 43.

price that would normally be obtained given its low rating. Economic theory, using the notion of decreasing utility, supports the view that such diversification, geared towards the individual appetite of investors, may enhance the value of the portfolio.

Rating agencies have an important role to play in this context. The legal rules governing the set-up of such transactions are often determined by the agencies themselves and are thus subject to Anglo-Saxon regulations. Credit cards are the most dominant category of ABS issuances.[67]

However, ABS also play a substantial role in the refinancing of home mortgage loans. A flexible ABS market for such debt (collateralized mortgage obligations) is a prerequisite for an efficient real estate loan market and can lead to a reduction of the spread between an interest free investment and a risk weighted investment.[68] Rating and ABS may, thus, jointly result in greater economic welfare for a society.

2.5. The conflict of interest

In the beginning, rating agencies were paid through subscription fees. Economically speaking, they provided a "screening"[69] service aimed at reducing information deficiencies. Moody's, now probably the most prominent of all rating agencies, published bond books and the company's revenues derived al-

[67] Frank J. Fabozzi, "The Handbook of Fixed Income Securities," 6th ed., chapter 32, (New York: Irwin Professional Pub. 2000), 751.

[68] As an alternative to using a rating, the credit spread as determined by the capital markets on exisiting financial products may be used as a fair estimate of the issuer's probability of default, cf. Petra Hüttemann, "Derivative Instrumente für den Transfer von Kreditrisiken," in: *Credit Risk und Value-at-Risk Alternativen, Herausforderungen für das Risk Management*, (Stuttgart: Schäffel-Poeschel Verlag, 1998), 52-76 (65).

[69] On the nature of "screening" as a device to reduce information assymetry, cf. John Riley, "Silver Signals: Twenty-Five Years of Screening and Signalling," *Journal of Economic Literature* 39 (2001), 432-478.

most entirely from the sale of these publications.[70] S&P is still in the hands of a publishing company, and the smallest of the three dominant rating agencies, Fitch, was established as the Fitch Publishing Company by John K. Fitch in New York on December 24, 1913.

Since the mid-1970s Moody's and its competitors agreed to rate securities that were uncommon for a fee. Nowadays, with some exceptions, all credit rating agencies operate on a fee basis.[71] In economic terms the information costs can be said to have shifted from the beneficiaries (the investors) to the initiators (the issuers). The certification-like procedure of today thereby fits into the economic models on information costs as a "signalling"[72] device.

Aside from this shift in the remuneration structure, a further fundamental change occurred with the governmental and courts' reliance on ratings.[73] Rating agencies find themselves confronted with a conflict of interest since, one the one hand, they are paid by the issuer but, on the other hand, the disclosed rating is geared towards the capital markets. If they publish benign ratings, the individual issuer will face lower borrowing costs; if their rating is "too" harsh, the issuer will not be willing to pay the fee or will not come back for another rating. The problem is similar to that of auditors. The auditor has to give an independent assessment of the financial situation of a company but receives his pay from the very company that he is about to scrutinize.

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[70] Moody's was established in New York by John Moody in 1900; on July 1 Moody's Investor Service was incorporated.

[71] Note, however, that Standard & Poor's, established in 1860 has been acquired by The McGraw-Hill Companies, a corporation that provides financial consulting and is active in the publishing business.

[72] On the nature of signalling, cf., for example, John G. Riley, "Silver Signals: Twenty-Five Years of Screening and Signalling," *Journal of Economic Literature* 39 (2001), 432-478. And A. M. Spence, "Job Market Signalling," *Quarterly Journal of Economics* 87, (1973), 355-374.

[73] An unparalleled description of the evolutionary history of rating agencies is by Frank Partnoy, "The Siskel and Ebert of Financial Markets? Two Thumbs down for the Credit Rating Agencies," *Washington University Law Quarterly,* vol 77, no. 3, (1999), 620-711.

Those who think rating agencies are doing their job and add informational value claim that the conflict of interest is checked and balanced by the need of rating agencies to maintain their reputational capital (reputation hypothesis). In a market in which the only true asset of a rating agency is its reputation, such a risk will usually be sufficient to cause the rating agency abstain from colluding with the issuer. This relation is – at least in a market without governmental reliance on ratings – intuitively convincing. As Frank Partnoy puts it:

> "…[T]he concept of "credit," broadly defined as the promise to pay in the future, includes notions of trust and credibility."

This statement relies on the assumption that the true asset of a rating agency is indeed its reputational capital. Whether rating agencies provide information or merely sell licenses to enter the capital markets, licenses which have been granted to them indirectly due to the extensive use of government regulation relying on ratings, continues to be disputed.

. There is some empirical evidence showing that Fitch's ratings are more favorable in many instances, while S&P and Moody's have become more conservative in their ratings over the years.[74] Conservatism alone, however, may be an argument against collusion, but does not necessarily indicate the truth in the claim that ratings have informational rather than licensing value. Some observers are extremely skeptical of the performance of rating agencies:[75]

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[74] Claire Hill, "Regulating the Rating Agencies, American" presented at the Law & Economics Association Annual Meeting, 2004, Paper 1, *Georgetown University Law Center, Business, Economics and Regulatory Policy, Working Paper* no. 452022, 64-65;
abstract of the paper can be found at
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=452022.

[75] Testimony of Jonathan R. Macey, Yale Law School, Before the House Committee on Financial Services on the proposed bill for "The Credit Rating Duopoly Relief Act of 2005,"

> "My law professor colleague Frank Partnoy has observed that credit rating agencies pose an interesting puzzle for those of use who study financial markets. On the one hand, a great deal of evidence indicates that their product, information, is not particularly inaccurate and, to the extent that it is accurate, by the time it reaches investors it is so stale that it is useless to the investors for whose ostensible benefit it was produced. The credit rating agencies dismal performance in their work on Orange County, Mercury Finance, Pacific Gas & Electric, Enron, WorldCom and most recently General Motors and Ford suggest that credit rating agencies aren't doing the job that the public thinks they are. A plethora of academic studies showing that credit ratings changes lag behind the changing market support this intuition.
> The best explanation for this puzzle of the credit agencies' simultaneously enjoying great success while providing no information of value to the investing public is that the SEC inadvertently created this problematic regulation when it misguidedly invented NRSRO designation. This designation has, over time, caused an artificial demand for ratings, despite their lack of usefulness to investors. Thousands of regulations, like Rule 2a-7 of the Investment Company Act of 1940, limit the ability of regulate financial intermediaries and financial institutions to invest in companies that lack NRSRO ratings."

As Claire Hill points out, the selling of regulatory access to the debt markets may, however, not be the reason for which ratings are sought. As pointed out before, most of the time issuers rely on Moody's and S&P for their expensive rating services. Fitch's ratings are generally cheaper and Fitch is also acknowledged by the SEC as a "Nationally Recognized Statistical Rating Organization" (NRSRO). Were not Moody's and S&P not perceived as more reputable than other agencies, why issuers still prefer their more expensive rating would remain inexplicable.[76] Moody's charges between €30,000 and

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November 29, 2005, accessible at
http://www.law.yale.edu/outside/html/Public_Affairs/678/Maceytestimony.pdf

[76] Claire Hill, "Regulating the Rating Agencies," presented at the American Law & Economics Association Annual Meeting, 2004, Paper 1, *Georgetown University Law Center, Business, Economics and Regulatory Policy, Working Paper* no. 452022, 2004, 67.

€250,000 per long-term note program, S&P "only" charges between €40,000 and €80,000 per first-time issuance.[77] In a four-year survey released in 2001 which received 309 responses from issuers, issuers were asked for the total fee amount to each rating agency on an annual basis. The result of this survey requesting the approximate amount in total fees is shown below:[78]

Figure 11: Approximate pay in total fees to each rating agency on an annual basis (US$ equivalent)

	S&P	Moody's	Fitch	Duff & Phelps (DCR)	Thomson Bank Watch (TBW)
Number of responses	278	263	68	107	37
Do not pay for ratings (%)	3.96	6.46	7.35	0.00	21.62
Less than $ 25000 (%)	11.51	9.51	19.12	14.95	32.43
$ 25000 to $ 50000 (%)	32.01	31.56	33.82	49.53	37.84
$ 51000 to $ 100000 (%)	26.98	23.19	23.53	19.63	5.41
$ 101000 to $ 200000 (%)	16.19	20.15	14.71	10.28	2.70
More than $ 200000 (%)	9.35	9.13	1.47	5.61	0.00

The survey showed that "banks tended to pay the highest fees, often up to four times the amount paid by industrials and utilities. On average, banks tended to pay more than $100000 per year, partly due to the amount of debt being issued. Utilities and industrials tended to pay on average between $25000 and $75000 per year. There is a clear correlation between rating levels and non-

[77] Guido Leidig, *Leistungsprofile von Rating-Agenturen, Abteilung Betriebswirtschaft,* (Wiesbaden: Bundesverband Druck und Medien e. V, 2003), 32 and 37.
78 The following questionnaire findings are taken from: Andrew Fight, *The ratings game,* (New York: John Wiley & Sons, 2001), 155-171.

payers. A significant percentage of issuers rated BB and B claimed they do not pay for ratings."[79]

These findings leave some doubt as to the independence of rating agencies, as do the survey results on the rating procedure. For example, the question as to whether the issuers had the opportunity to review rating agency write-ups on the company before they were published received the following the responses:

Figure 12: Percentage-opportunity to review rating agency write-ups on company before publication

	S&P	Moody's	Fitch	Duff & Phelps (DCR)	Thomson Bank Watch (TBW)
Number of responses	295	282	77	123	36
For factual information only (%)	31.86	35.82	32.47	27.64	27.78
For factual and analytical information (%)	59.32	50.71	66.23	69.92	66.67
Unable to review write-ups (%)	8.81	13.48	1.30	2.44	5.56

Again the procedure leaves some doubts regarding the impartiality of rating agencies. While it does not seem surprising to find that Moody's and S&P, the market leaders, allow less review opportunities compared to other rating agencies, the number of rating actions in which the issuer is allowed a review prior to the public announcement of the rating is astonishingly high; 50.71% and 59.32% for Moody's and S&P respectively.

Also, the reported numbers on the percentage of unsolicited ratings leaves the observer feeling somewhat uneasy about the impartiality of rating

[79] Andrew Fight, *The ratings game*, (New York: John Wiley & Sons, 2001), 168.

agencies and potential extortion practices. Answers to the question of whether the initial rating was requested or unsolicited were as follows:

Figure 13: Percentage of companies whose initial ratings were unsolicited

	S&P	Moody's	Fitch	Duff & Phelps (DCR)	Thomson Bank Watch (TBW)
Number of responses	284	271	79	110	41
Percent requested	94.01	90.41	73.42	94.55	63.41
Percent solicited	5.99	9.59	26.58	5.45	36.59

In Moody's case, it seems that corporate policy has changed over the last several years. Moody's Frankfurt has stated that the group stopped the practice of issuing unsolicited ratings some years ago.

2.6. The economic unlikelihood of the risk of abuse

If the fee paid for the rating could "buy" a certain rating, then surely the fee would be comparable to a bribe and abuse would be a predominant feature of the rating business. However, other impediments to the abuse of discretion aside, reputation risks alone should usually be sufficient to prevent abuse by the rating agency. The rating agencies are repeat players and the individual fee for a rating is not sufficient to offset the price of an unduly favorable rating.

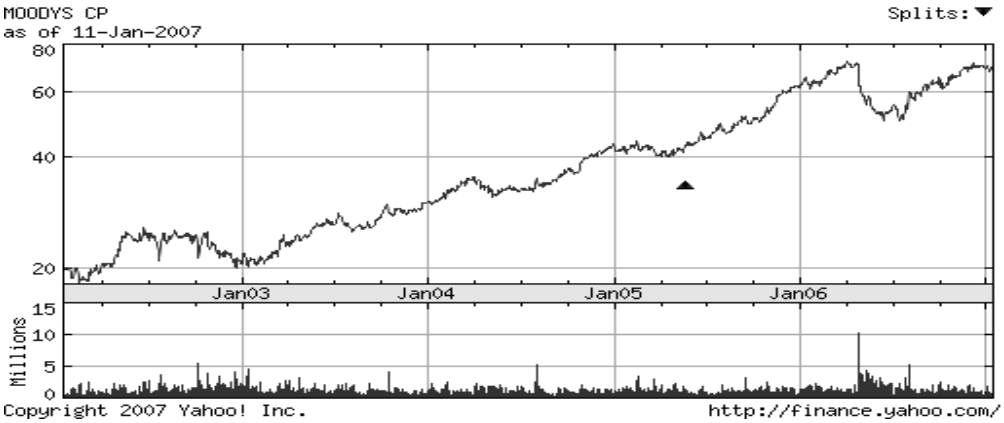
The three most reputable rating agencies in particular have too much at stake to be willing to risk losing their reputation on one individual client. Looking at Moody's, which is the only freely tradable rating agency, the stock price development tells us just how profitable the business that the company is pursuing is. Moody's profit margins have been as high as 50%, and indeed one ana-

lyst characterized Moody's as "the best franchise [he's] ever covered in [his] 20 years on Wall Street."[80]

In 2002, Moody's charged, in addition to an annual fee, between $33,000 and $275,000 per issue based on the par value and complexity of the issue. The standard per issue fee was calculated as 0.033 percent of the first $500 million of par value and 0.02 percent of additional par value, with $33,000 minimum and $275,000 maximum.[81]

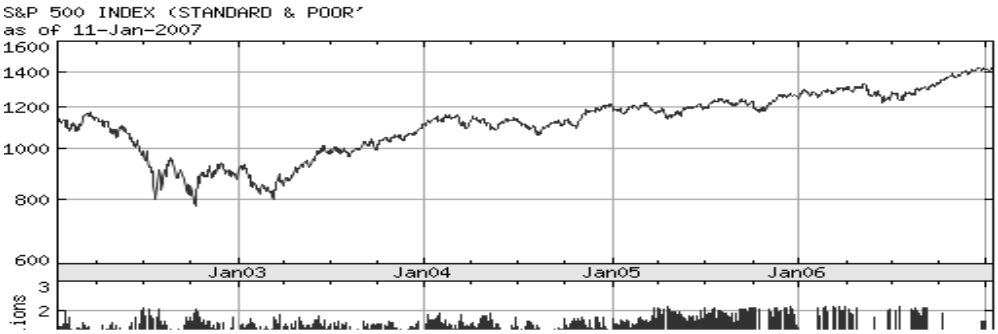
[80] Leslie Wayne, "Credit Raters Get Scrutiny and Possibly a Competitor," *New York Times*, April 23, 2002, C 10 (quoting Bear Stearns analyst Kevin R. Gruneich).
[81] Daniel M. Covitz (Federal Reserve Board), Paul Harrison (Federal Reserve Board), "Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate," *Federal Reserve Board Finance and Economics, Working Paper Series*, n° 2003/68, 7.

Figure 14: Moody's share development (in US Dollar, NASDAQ-Quote)



The analyst's comment rings particularly true when these figures are compared with the general market development.

Figure 15: S&P 500 figures



Thus, in general it can be assumed that the rating business is negatively correlated to the general market risk, and that with a ß of less than 1, it is an extremely profitable business (Market Price of Stock/earnings per share = 26.89). Traditional methods of enterprise valuation rely on the ß hypothesis. The more a stock can offset the risk of a portfolio (i.e. the smaller its ß value), the smaller the expected earnings that the market demands from the venture).

Nevertheless, the problem of potential abuse bears comparison to that concerning the independence of auditors. Arthur Andersen was undoubtedly a respected company before certain individuals aided and abetted Enron in its securities fraud. Arthur Andersen's main asset likely also consisted of its reputation, but still, the incentive structure of the firm did not act as a deterrent to the aiding and abetting of Enron in corporate fraud. Behavioral finance has already recognized the need to view transactions not only from the point of view of institutions, but also from the point of view of individuals. Thus, in some situations individual analysts working at rating agencies will still feel tempted to issue benign ratings. This becomes especially apparent in situations where individual analysts receive non-monetary benefits from, for example, attending road shows run by the management, or where they enjoy the sense of belonging and respect that the position of an analyst at one of the rating agencies entails.

From the institutional side, however, some major differences remain between auditing reports and rating reports. Auditing reports typically consist of boilerplate language with many limitations regarding the scope of the report. Auditing rarely results in the unwillingness of the auditing firm to formally approve the accounting system of an enterprise. If concerns are raised, these concerns are typically only communicated to senior management. It has, at least in the past, been the practice in business to verbally communicate any concerns to senior managers without fully informing the board or supervision staff. Some-

times, drafts are used as a means of avoiding public transparency with respect to problematic issues.

As a result, the general public of investors does not view the typical boilerplate auditing report as being essential to its evaluation of a firm's creditworthiness or outlook. Rating reports on the other hand, do have an immediate impact on the pricing of an issuance. In fact, since the technicalities of bond issuances are so complex, it is fair to assume that many investors rely to a large extent on the advice of rating agencies. Thus, the accuracy of a rating report is likely aimed at the investor for whom a boilerplate auditing report is not appropriate.

It might, therefore, be generally assumed that there are sufficient objective checks and balances that deter credit agencies from abusing their power.[82] In peripheral markets, where the dominant players are not yet protected by a monopolistic market structure, the temptation to cheat on the general public might be too great. Furthermore, and as has not yet been covered in this analysis, abuse by individuals within a rating agency, or mere negligence, cannot be avoided by reputation incentives.

[82] Roy C. Smith and Ingo Walter, "Rating Agencies: Is There an Agency Issue?, Stern School of Business," New York University: Draft of February 18, 2001, also reprinted as pages 289-318 in: Levich, Richard M. / Majnoni, Giovannie / Reinhart, Carmen M. (eds), *Ratings, Rating Agencies and the Global Financial System*, Boston: Kluwer 2002; Smith and Walter leave that general question open. Gudula Deipenbrock explains the arguments for and against regulation and supports the view that self-regulation is insufficient, "Aktuelle Rechtsfragen zur Regulierung des Ratingwesens," *WM* 2005, 261 (262).

2.7. The negative correlation between the risk of abuse and competitive pressure

In the US, Moody's, S&P and Fitch can pursue their business interests relatively free of competition. Even though as many as 74 rating agencies[83] have been counted, those deemed as relevant number no more than two, or at the most, three if Fitch is included.

Since 1975, the Securities and Exchange Commission has relied on credit ratings from these three "nationally recognized statistical rating organizations," NRSROs, in order to distinguish among grades of creditworthiness in various regulations under the federal securities laws.[84] Recently, the SEC awarded Bond Rating Service Ltd. the Status of NRSRO, increasing the number of NRSROs to four.[85] The SEC ruled that broker-dealers would have to levy smaller capital charges on investment graded debt securities under the Net Capital Rule than on non-investment graded securities. Under the Net Capital Rule broker-dealers had to deduct certain percentages of the market value (the so-called "haircut) of their proprietary securities positions from their net worth to calculate their required net capital. "Among others, broker-dealers' proprietary positions in commercial paper, non-invertible debt securities, and non-invertible preferred stock were accorded preferential treatment if the instru-

[83] For a list of the most prominent rating agencies, cf. John B. Caouette, Edward I. Altman, Paul Narayanan, *Managing Credit Risk, The Next Great Financial Challenge,* (New York 1998), 67; cf. also www.defaultrisk.com/rating_agencies.htm for a list of rating agencies.
[84] SEC Concept Release: "Rating Agencies and the Use of Credit Rating under the Federal Securities Laws," Release no. 33-8236.
[85] www.sec.gov/answers/nrsro.htm (modified 3/07/2003).

ments had been rated investment grade by at least two nationally recognized statistical rating organizations."[86]

This "haircut" was required for highly rated securities as it was assumed these would be more liquid and less volatile. [87]

Most notably, on the basis of Rule 15c3-1 under the Exchange Act, the Commission determined capital charges for brokers or dealers with regard to the different rating grades for debt securities. According to Rule 2a-7 under the Investment Company Act of 1940, money market funds may only invest in "high quality securities"; that standard is defined based on an objective test, i.e. the rating issued by NRSROs, and based on a subjective test, i.e. the credit analysis performed by advisers for the money market fund.[88] The reliance on rating is further enhanced by the individual statutes of the rating funds that often restrict their investment behavior to investment grade-rated securities.[89]

Four US based non-NRSRO agencies have gained some acceptance by the SEC and received "no-action letters with respect to NRSRO status." The result was that broker-dealers relying on such ratings would not be subject to actions by the SEC for failing to rely on an NRSRO. In the meantime however, all such partially recognized rating agencies have merged with an NRSRO.[90]

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[86] Quote taken from: Andrew Fight, *The ratings game*, (New York: John Wiley & Sons, 2001), 223.

[87] "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets" (as required by Section 702(b) of the Sarbanes-Oxley Act of 2002), Pub. K. no.: 107-204, s. 702(b), 116 Stat 745 (2002), 6.

[88] Unfortunately, both these rules are not contained in the general compendium of securities laws of Thomas Lee Hazen, "Securities Regulation, Selected Statutes, Rules and Forms," 2003 Edition, Thomson West Group; the assessment of the importance of the two cited rules stems from the SEC itself, SEC Concept Release: "Rating Agencies and the Use of Credit Rating under the Federal Securities Laws," Release no. 33-8236, 3.

[89] Cf. Boris Hrubesch, Jürgen Witte, "Rechtsschutzmöglichkeiten beim Unternehmensrating," *Zeitschrift für Wirtschaft (ZIP)* no. 29 in 2004, 1346, 1347.

[90] Cf. "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets" (as required by Section 702(b) of the Sarbanes-Oxley Act of 2002), Pub. K. No: 107-204, s. 702(b), 116 Stat 745 (2002), 9.

Competition is still a relevant factor in specialized industries and in non-core financial markets. In the insurance sector, for example, AM Best is the dominant rating agency covering 44% of all insurance ratings.[91]

In other countries, however, the three dominant players are still competing with other rating agencies. In those countries where competition thrives, most people live on the periphery of financial centers. Individual abuse in those countries will be less transparent on the less-observed market place and will not threaten the reputation of the dominant rating agencies as much as a wrongful rating in one of the key markets. Therefore, the temptation to "cheat" is greatest in countries where asymmetric information is also greatest. This is particularly true as in many of these countries the three dominant rating agencies do not act themselves, but rather, are active via joint ventures with local rating agencies.

Time-wise, competition and the potential threat of "rating shopping" is also greatest at critical rating thresholds, especially when there is doubt as to whether or not the security can be investment graded.[92] Due to regulations or market pressures, most mutual funds may only invest in investment-graded securities, thus the acquisition the BBB-grading is not only beneficial to the issuer, but also crucial to the successful issuance of securities.

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[91] Paul Maynard, Managing Director - UK Portfolio Management Board, Corporate Division, AON, citing Swiss Re Economic Research & Consulting estimates; for a list of insurance rating agencies, cf. www.einsuranceprofessional.com.

[92] Roy C. Smith and Ingo Walter, "Rating Agencies: Is There an Agency Issue?," Stern School of Business, New York University: Draft of February 18, 2001, 20, also reprinted as pages 289-318 in: Levich, Richard M. / Majnoni, Giovannie / Reinhart, Carmen M. (eds), *Ratings, Rating Agencies and the Global Financial System*, Boston: Kluwer 2002.

3. The Regulation of Rating Agencies

This chapter will deal with the existing and potential future regulation of rating agencies. Much of the debate stems from the failure of rating agencies to correctly alert the general public about major corporate bankruptcies. The reactions of SEC and by the European Union will be discussed.

Steven L. Schwarz categorizes the potential regulation of rating agencies: "Regulation can be divided into self-regulation and government regulation, and the latter can be further subdivided into the administrative system of direct public control and the judicially enforced system of private rights."[1]

If regulation is defined this broadly, then private litigation also becomes part of regulation. However, in the present context regulation shall be understood in the limited sense of direct public control or self-regulation, with litigation remaining a separate issue to be treated later.

It is relatively difficult to provide a complete picture of the regulation of the rating business. Many countries have opted for some governmental control of rating agencies, notably those countries that are not necessarily at the center of international finance (Argentina, Chile, Korea and India).[2] Internal ratings are, if available at all, governed by banking law principles and have thus become part of the scope of Basel II and the national implementation measures accompanying the Basel II agreement.

External rating agencies have, however, no direct linkage to the banking regulation given that they are used by others to help assess the quality of an in-

[1] Steven L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox," *University of Illinois Law Review*, issue no. 1, 2002, page 2, footnote 6.
[2] Steven L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox," *University of Illinois Law Review,* issue no. 1, 2002, 3-4.

vestment rather than the credit policy of the bank itself. They raise many further questions which remain unanswered.

It should be pointed out in this context that the resolution to these issues is most likely to come from the top level international arena and will probably include very few national idiosyncrasies. External ratings are of particular importance where the targeted investor base is international and it would be odd to have different regimes depending on where the investors happen to be located.

As mentioned earlier, IOSCO has given recommendations for the regulation of external rating agencies. Unfortunately, the Committee of European Securities Regulators, CESR (a forum of national EU securities regulators), has already begun to deviate slightly from the IOSCO proposals.

Much confusion has been caused within the context of national implementation of EU law by national legislators, who have added additional layers of regulation to their national implementation measures (so-called "gold-plating"). If CESR is already contemplating diverging from the IOSCO proposals, how much regulative unity will remain at the level of national implementation?

The IOSCO code is of particular importance and has, therefore, been included as an appendix. Unlike the EU Commission, IOSCO has no rule-making authority but may address its recommendation to its members for implementation through them. IOSCO has 108 ordinary members, 65 affiliate members and 10 associate members in almost all countries in the world. Nevertheless, its recommendations, quintessentially "soft law," will have a binding effect on its members in practice. The European Union as such is not a member. In the case

of Enron, rating agencies failed miserably to correctly predict the risk of insolvency.[3] The rating agencies rated Enron to be an "investment grade."

3.1. Failure of rating agencies

In the case of Enron, there was an outright failure on the part of rating agencies to correctly predict the risk of insolvency. Rating agencies gave Enron an "investment grade" rating only four days before the company declared bankruptcy.[4] Senator Joseph Lieberman noted:

> "The credit-rating agencies were dismally lax in their coverage of Enron. They didn't ask probing questions and generally accepted at face value whatever Enron's officials chose to tell them. And while they claim to rely primarily on public filings with the SEC, analysts from S&P not only did not read Enron's proxy statement, they didn't even know what information it might contain."[5]

[3] In the EU, the international insolvency regulation determines which country has the right to open proceedings (center of main interest – test); even the accessory countries have already adopted similar regimes, cf. Ieva Azanda, Oliver von Schweinitz, "Romanian International Insolvency Law," May 2004, International Insolvency Institute, http://www.iiiglobal.org/country/romania/Romanian_Insolv.pdf.

[4] Claire Hill, "Regulating the Rating Agencies," presented at the American Law & Economics Association Annual Meeting, 2004, Paper 1, *Georgetown University Law Center, Business, Economics and Regulatory Policy, Working Paper*, no. 452022, 1; "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets" (as required by Section 702(b) of the Sarbanes-Oxley Act of 2002, Sarbanes-Oxley Act of 2002, Pub. K. no.: 107-204, s. 702(b), 116 Stat 745 (2002), 4.

[5] Senate Committee on Governmental Affairs, Press Release, Financial Oversight of Enron: The SEC and the Private-Sector Watchdogs (Oct. 7, 2002) (statement of Chairman Joe Lieberman), at http://www.senate.gov/~gov_affairs/100702press.htm.

3.2. And the reaction of the U.S.: The Rating Agency Reform Act

In its general aim to increase the independence of "watch-dogs," the US Congress has, via the Sarbanes-Oxley Act,[6] increased the regulatory grip on rating agencies.[7] According to Section 702 of the Sarbanes-Oxley Act, the Commission has conducted a study of the role and function of credit rating agencies in the operation of the securities market. According to Section 702(a)(2), the study examined in particular any barriers to entry into the business of acting as a credit rating agency and any measures needed to remove such barriers as well as any conflicts of interest in the operation of credit rating agencies and any measures aimed at preventing such conflicts or at ameliorating the consequences of such conflicts. According to the SEC's study, the single most important criterion for qualifying as NRSRO under the old ("no-action letter") approval system was that the rating agency must be widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings. That criterion did, however, have the effect of a catch-22: in order to become a Nationally Recognized Statistical Rating Organization, a rating agency had to be "recognized by the business community." However, the business community did not recognize a rating agency without recognition by the SEC. The vagueness of the criterion ("recognition by the business community") led to a state-protected triopoly of the three existing dominant players (Moody's, S&P, Fitch), thereby reducing the degree of competition among them. At the time of the introduction of the NRSRO initial approval system,

[6] For the important spill-over effect of the Sarbanes-Oxley Act, Oliver von Schweinitz, "The impact of Sarbanes-Oxley on foreign jurisdictions," *DAJV-Newsletter* 2/2003, 79-81.
[7] Nevertheless, Moody's generally welcomed the new emphasis of issuer on accounting control resulting from the Sarbanes Oxley act. Cf. Economist, Special Report: Auditing Sarbanes-Oxley, A price worth paying?, America's response to Enron and other scandals was the Sarbanes-Oxley law. It is costing plenty – but is it working?, Date May 21, 2005, page 73-75.

that effect might even have been welcomed. The flip side of stifling competition was also that "rating shopping" was not possible for issuers and thus that the independence of the dominant players was strengthened. When ENRON showed, however, how miserably the triopoly had failed to detect the massive fraud by ENRON's management, this showed that a system of inefficient competition was not best fit to detect fraud. Thus, first the House of Representatives (through the proposed "Credit Rating Agency Duopoly Relief Act), then the Senate moved and Congress enacted the "Credit Rating Agency Reform Act of 2006." The Act is reprinted as Appendix 2 to this book for your convenience.

The Credit Rating Agency Reform Act has taken away much of the regulatory barrier to this market existing under the old approval system. Said Act replaced the ("no-action letter") approval system by a registration system in order to obtain NRSRO status. The idea goes back on a proposal by Claire Hill. She suggested some form of regulatory supervision ranging from admission under new explicit criteria for the obtainment of NRSRO status to a simple public registration procedure with the SEC.[8.] This view has now become law by the Credit Rating Agency Reform Act.

The Credit Rating Agency Reform Act is more balanced and temperate in its approach to increase competition than the House of Representatives proposed "Credit Rating Agency Duopoly Relief Act". The "Credit Rating Agency Duopoly Relief Act" would have led to the existing NRSRO's loss of their privileged status; in its pertinent part the Credit Rating Agency Duopoly Relief Act would have provided:[9]

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[8] Claire Hill, "Regulating the Rating Agencies," presented at the American Law & Economics Association Annual Meeting, 2004, Paper 1, *Georgetown University Law Center, Business, Economics and Regulatory Policy, Working Paper*, no. 452022, 2004, 45.

[9] Proposed section 4 of the "Credit Rating Agency Duopoly Relief Act of 2005" as it would amend Sec. 15E of the Securities and Exchange Act of 1934 by inserting a new section "Registration of Statistical Rating Organizations" in sec. 15(j)(1). The Credit Rating Agency

> "The no-action relief that the Commission has granted with respect to the designation of nationally recognized statistical rating organizations, as that term is used under rule 15c31 of the Commission's rules (17 C.F.R. 240.15c31), shall be void and of no force or effect."

That intended clearance of the competitive field has not become law. Instead the House of Representatives and the Senate in Congress assembled enacted the "Credit Rating Agency Reform Act of 2006." This Act now foresees for a "grandfathering" of the existing NRSRO approved rating agencies. The now enacted Credit Rating Agency Reform Act provides (section 15E (a)(1)(D)):

> "(D) EXEMPTION FROM CERTIFICATION REQUIREMENT –
> A written certification under subparagraph (B)(ix) is nor required with respect to any credit rating agency which has received, or been the subject of, a no-action letter from the staff of the Commission prior to August 2, 2006, stating that such staff would nor recommend enforcement action against any broker or dealer that considers credit ratings issued by such credit rating agency to be ratings from a nationally recognized statistical rating organization."

The NRSRO approved rating agencies will thus be subjected to the same review process leading to "registration" as exists now for new market entrants, but will not have to produce "certifications" from qualified institutional buyers. This "grandfathering" provision makes sense as their market recognition is publicly known and having to produce such information would be redundant.

Duopoly Relief Act is a bill proposed by the House of Representatives but has to be adopted by both Senate and House of Representative in session as Congress, 109th Congress, H.R. 2990, introduced in the House of Representatives (HR) on Jun 20, 2005 by Rep. Michael Fitzpatrick Republican of Pennsylvania (Co-Sponsors: Rep. W. Todd Akin [R-MO],Rep. Richard Baker [R-LA], Rep. James Barrett [R-SC], Rep. Michael Castle [R-DE], Rep. Geoff Davis [R-KY],Rep. Philip English [R-PA], Rep. Tom Feeney [R-FL], Rep. Mark Foley [R-FL], Rep. E. Scott Garrett [R-NJ], Rep. Jim Gerlach [R-PA], Rep. Paul Gillmor [R-OH], Rep. Melissa Hart [R-PA], Rep. Patrick McHenry [R-NC], Rep. Michael Oxley [R-OH]).

As a result of the old approval system, sooner or later, a big issuer of securities had to come back to one of these even if he should have received a negative rating. Nobody knows how the new Credit Agency Reform Act will affect this market. Under the old approval system Claire Hill observed, however, that issuers typically attempted to obtain both Moody's and S&P ratings, and very occasionally used Fitch as a third rating. Hill suggested that Fitch was used for a third rating if Moody's and S&P ratings did not coincide. It seemed that Fitch was seldom used as a second rating, and more rarely still as the only rating. The market apparently recognized as a customary business rule a "two-rating norm," in which the two ratings are those of Moody's and S&P.[10]

In some cases this custom even entered financial legislation. In fact, a dual rating is often required for a security in order for it to be eligible for institutional investors. Thus, the customary "rule" and the legal regulations served to reinforce one other.

Congress has now passed a bill whose clear intention is to lead to "additional competition". As mentioned above, the first impetus to amend the law came from the House of Representative, which proposed "The Credit Rating Agency Duopoly Relief Act"[11]. It contained the following provisions in the most pertinent section:

> "(a) REGISTRATION REQUIRED.--Except as provided in subsection (b), it shall be unlawful for any statistical rating organization, unless registered under this section, to make use of the mails or any means or

[10] Claire Hill, "Regulating the Rating Agencies," presented at the American Law & Economics Association Annual Meeting, 2004, Paper 1, *Georgetown University Law Center, Business, Economics and Regulatory Policy, Working Paper*, no. 452022, 60.

[11] 109th Congress, H.R. 2990, introduced in the House of Representatives (HR) on Jun 20, 2005.

> instrumentality of interstate commerce in connection with its business as a statistical rating organization.
>
> b) EXCEPTIONS.--The Commission, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from subsection (a) of this section any statistical rating organization specified in such rule or order."

The "Credit Rating Agency Duopoly Relief Act" did not find the approval of the Senate. While the Senate approved the idea of replacing "NRSRO approval" by "registration", the registration *requirement* effectively precluded new entrants to the market. Had the Credit Rating Agency Duopoly Relief Act become law, then new credit rating agencies would have had to apply for "registration" and only upon receiving such registration be allowed to enter into this market. That would have lead to a necessity of the SEC to exercise content control over the worthiness of the applicant.

The Senate responded to the House of Representative's proposal by himself proposing an amended bill on the same matter which finally became law as the "Credit Rating Agency Reform Act of 2006". This bill allows for a credit rating agency to "*elect*[12] to be treaded as nationally recognized statistical rating organization" but does not *require* such status to be active in this business. The registration shall "contain information regarding-:

> (i) credit ratings performance measurement statistics over short-term, mid-term, and long-term periods (as applicable) of the applicant;
> (ii) the procedures and methodologies that the applicant uses in determining credit ratings;
> (iii) policies or procedures adopted and implemented by the applicant to prevent the misuse, in violation of this title (or the rules and regulations hereunder), of material, nonpublic information;
> (iv) the organizational structure of the applicant;

[12] [emphasis added]

> (v) whether or not the applicant has in effect a code of ethics, and if not, the reasons therefor;
> (vi) any conflict of interest relating to the issuance of credit ratings by the applicant;
> (vii) the categories described in any of clauses (i) through (v) of section 3(a)(62)(B) with respect to which the applicant intends to apply for registration under this section;
> (viii) on a confidential basis, a list of the 20 largest issuers and subscribers that use the credit rating services of the applicant, by amount of net revenues received therefrom in the fiscal year immediately preceding the date of submission of the application;
> (ix) on a confidential basis, as to each applicable category of obligor described in any of clauses (i) through (v) of section 3(a)(62)(B), written certifications described in subparagraph (C), except as provided in subparagraph (D); and
> (x) any other information and documents concerning the applicant and any person associated with such applicant as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors."

All of these steps should be welcomed as they will increase the public accountability and rationality of the rating industry. However, one may question whether the disclosure on procedures and methodologies (ii) is warranted. This may eventually force rating agencies to disclose their franchise to their competitors. Thus, there is a risk, that this requirement may place disincentives on innovation.

It is not yet clear what function this list of items will have. "Registration" sounds at first as if the SEC were only allowed to control that the items to be disclosed were complete and that registration would be different from "approval". However, the SEC may according to section 15E (a) 2 review then application and "grant such registration" or "institute proceedings to determine whether the registration should be denied". In practice, this could lead to the effect that NRSRO former approval proceeding granted by "no-action letter" is

not so different from the now-installed "registration" procedure after all, were it not for the difference that the criteria for "registration" are now more clearly discernable.

To what degree the SEC is granted only a formal review authority over the completeness of the application and to what degree it may exercise the authority to review the material worthiness of the applicant's business case (in particular the worthiness of his policies and procedures) will depend on the future handling of the Act by the SEC. Section 15E (a) 2 (C) leaves that question open by stating that the SEC shall grant registration "if the Commission finds that the requirements (…) are satisfied".

More speaks in favor of a formal review process. The requirements themselves seem to be formal ("shall contain information") rather than material requirements. However, what shall happen if the applicant has provided the SEC with information regarding its procedures but these are deemed insufficient by the SEC's staff? In that case, shall the SEC be bound to approve the applicant although it can foresee that the procedures are insufficient to protect the confidentiality of information vis-à-vis third parties? If the SEC now is granted enforcement powers (section 15E (d) of the Credit Rating Agency Reform Act), should it be blind in the application stage? Probably not, the Act states that credit rating agencies are "of national importance" and that the "oversight of such credit rating agencies serves the compelling interest of investor protection". In light of these "Findings" (cf. section 2 of the Credit Rating Agency Reform Act), the SEC must have the authority to strike down apparently misguided applications.

At the same time, the Credit Rating Agency Reform Act states that "additional competition is in the public interest". If the barriers to entry into the market as NRSRO were understood both as formal and material requirements,

then in fact the NRSRO "registration" process would come close to the old NRSRO "approval" process, which it is meant to replace. Thus, the registration requirements should be interpreted so as to allow the SEC only limited review on the material soundness in particular vis-à-vis the policies and procedures proposed by the applicant. If these policies and procedures do not lead to the apparent conclusion that securities laws may be breached as a result of their application by the applicant, then NRSRO "registration" should be granted. It should not be the charge of the SEC to review whether the proposed policies and procedures are perfectly fit to counter conflict of interest, it should be sufficient that the rating agency applicant addresses the issue in such a way that it probably will not conflict with securities laws.

This interpretation is backed by the *telos*, the purpose, of the requirement to accompany each application with written certifications from 10 qualified institutional buyers (QuIBS). These QuIBS shall not be liable in any private right of action for any opinion or statement expressed in a certification made (section 15E (a)(1)(E) of the Credit Rating Agency Reform Act). If the QuIBS have to lend their moral support to the application, then this speaks in favor of the idea, that the worthiness of the applicant to receive NRSRO status has to be outside the scope of the review authority of the SEC. The material worthiness of the applicant to receive NRSRO status should thus be something left to market powers and the willingness of market participants to lend their reputation to the creation of an additional market player. The process as such is comparable to the candidate nomination of traditional election systems, where the merits of the candidacy is left to the public and not subject to control by the public authorities.

If the application procedure is interpreted in this way, the Credit Rating Agency Reform Act will indeed bring much needed (actual and potential) com-

petition to this market and foster the innovativeness of the US and global capital markets.

It should be noted that Moody's itself has proposed abandoning the NRSRO designation by the SEC. Being wary why Moody's as the beneficiary of NRSRO status made such proposal, it may be expected, that the simple abolition of NRSRO status would have resulted in even greater concentration in the rating business and not in an increase in competition among rating agencies. This inference may, by way of comparison, be derived from the OTC market. The market for complex financial products (swaps, credit-derivatives) is generally more concentrated than the (regulated) markets of a stock-exchanges. OTC markets have no admission procedure and information deficiencies or distrust among traders is thus greater in the OTC market, than in a regulated market. This leads to the general conclusion, that in markets with great information deficiencies the lack of regulation may lead to market concentration among repeat players. A similar inference is true for the underwriting market, which is dominated by few institutions with excellent reputation (Goldman Sachs, Merril Lynch, Citigroup, Morgan Stanley, JP Morgan, Deutsche Bank, etc.).

Recognition through governmental authorities, even though it once led to the dominance of Moody's and S&P, may therefore nowadays be the only option to increasing the number of potential players in the lucrative market of ratings. First and foremost, whether the existence of a greater number of competitors is indeed a desirable outcome would have to be verified. Greater competition might decrease the independence of rating agencies, thereby reducing the reliability and quality of ratings. Accordingly, NRSRO status recognition cannot be seen to have merely negative consequences.

Publicity of the procedure seems to be important to provide for the "shaming" of those candidates that lose NRSRO status.[13] If section 15E (d) allows for the SEC's revocation of the "registration" status and section 15E mandates to "make the information and documents submitted to the Commission in its completed application for registration, or in any amendment submitted (…) publicly available on its website (…), then obviously "Shaming" will be the intended sanction for ill-performance of rating agencies.

Claire Hill also favors the creation of a public forum in which market participants would comment on rating agencies' performance, but that idea has not been implemented by the Credit Rating Agency Reform Act.[14] Other countries have, however, implemented that idea of public peer pressure into their capital markets laws. The idea of a public forum to enhance governance structures has for example been applied by the German legislature to increase corporate governance.[15] A public forum control should also be considered for rating agencies. Issuers are effectively at the mercy of the rating agencies (they may change only once amongst the three dominant rating agencies without conflicting with the "two ratings rule"). Thus, there is no effective market peer pressure. In addition, the judicial control has so far been residual. In such cases effective control is likely to come more from public opinion than from legal pa-

[13] Similar considerations may have motivated the German Act for the Improvement of Transparency on Manager Remunerations, cf. Baums, Theodor, "Vorschlag eines Gesetzes zur Verbesserung der Transparenz von Vorstandsvergütungen," *ZIP* 2004, 1877-1884 (1879).
[14] Claire Hill, "Regulating the Rating Agencies," presented at the American Law & Economics Association Annual Meeting, 2004, Paper 1, *Georgetown University Law Center, Business, Economics and Regulatory Policy, Working Paper*, N° 452022, 2004, page 45.
[15] A "shareholders' forum" has been introduced by the German legislature through the Act for the Integrity of Businesses and for the Modernization of Shareholder Suits ("Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts – UMAG," as of Sept. 2, 2005, *BGB*l. I 2802) thereby implementing a new section: 127a of the Act on Public Companies ("Aktiengesetz"), cf. on the practical handling of this forum, Jörg H. Geßler and Markus Käpplinger, "Aktiengesetz," commentary (leaflet), vol. 1, 50. up-date, June 2006, (München: Beck Verlag) section 127a, annotations 1-6.

rameters. To that effect a public forum of market comments should be an effective tool.

Section 15E (i) of the Credit Rating Agency Reform Act enables the SEC to issue rules to prohibit any act or practice relating to the issuance of credit ratings by a nationally recognized statistical rating organization that the SEC determines to be "unfair, coercive, or abusive", including any "act or practice relating to:

> (A) conditioning or threatening to condition the issuance of a credit rating on the purchase by the obligor or an affiliate thereof of other services or products, including pre-credit rating assessment products, of the nationally recognized statistical rating organization or any person associated with such nationally recognized statistical rating organization;
> (B) lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets within such pool or part of such transaction, as applicable, also is rated by the nationally recognized statistical rating organization; or
> (C) modifying or threatening to modify a credit rating or otherwise departing from its adopted systematic procedures and methodologies in determining credit ratings, based on whether the obligor, or an affiliate of the obligor, purchases or will purchase the credit rating or any other service or product of the nationally recognized statistical rating organization or any person associated with such organization."

It may be too early to predict whether these prohibitions to be erected by the SEC will have a substantial impact. Conditions (A) and (B) explicitly named here will probably not show effects. While condition (A) prohibits to link the appraisal to the sale of supplementary services, it does not prohibit to render those services in the first place. Thus, the temptation to corrupt ratings (or be corrupted) by pre-rating services will persist. Similarly, condition (B) is

intended to prevent extortion of issuers, but the subtleties of economic interdependence between rating agencies will continue.

Probably, condition (C) will have a greater impact if the SEC holds rating agencies to their own publicly dispersed standards. The standards of a rating agency will thus become something like a public-law contract between the rating agency applicant and the SEC. The private law effects of the policies and procedures still remain, however, to be seen. The issue of potential liability of a rating agency for its actions vis-à-vis the issuer and third parties under U.S. law is further discussed in chapter 5 (please see for the issue of private rights of action, page 94et seq.). The pros and cons of further regulation are discussed in chapter 9.

3.3. And the reaction of the EU

After the collapse of Enron, the Economic and Financial Affairs Council, ECOFIN, requested that the European Commission in April 2002 assess the activities of credit rating agencies. As a result, the European Commission held several discussions on the subject in the European Securities Committee, ESC. In February 2004, the European Parliament called on the Commission to submit its assessment of the need for appropriate legislative proposals to deal with credit rating agencies[16] by July 31, 2005.

What Enron has been to the US, Parmalat has (to a lesser degree) been to the EU. In March 2004, following the Parmalat scandal, the EU reinforced its analysis. Rating agencies had once again failed.[17] As in the Enron case, the

[16] Call to CESR for technical advice on possible measures concerning credit rating agencies, call for evidence, Ref.: CESR/04-394.
[17] Although on December 18, 2003, Moody's reported high Parmalat exposure in collateralized debt obligations, on February 3, 2005 it affirmed the rating on three classes of notes issued.

management had acted fraudulently and since rating agencies generally rely on the information supplied to them by the management in question, the ratings again could not accurately reflect the critical stage of the company's development. The EU Commission presented the four core issues to the European Securities Committee, which it believed needed to be addressed in relation to credit rating agencies:

i. potential conflicts of interests within rating agencies;
ii. transparency of rating agencies' methodologies;
iii. legal treatment of rating agencies' access to inside information; and
iv. concerns about possible lack of competition in the market for the provision of credit ratings.

It then called the Commission of European Securities Regulators, CESR, for technical advice on possible measures concerning credit rating agencies.[18] The deadline for the delivery of CESR's technical advice was set to be April 1, 2005. On November 30, 2004 CESR presented a consultation paper on the issue.[19]

In March 2005, CESR published a feedback statement based on the results obtained from questionnaires sent out to market participants and announced its technical advice. Finally, on January 9 2006, the European Commission adopted a Communication setting out its approach to credit rating

http://www.moodys.com/moodys/cust/qckSearch/qckSearch_search_result.asp?n_id=600020157&fr_ref=C&PB2_nam=Parmalat+S%2Ep%2EA%2E&searchQuery=parmalat&search=1&searchIdent=qcksearch&searchresult=named&portid=&frameOfReference=corporate.

[18] European Commission, Internal Market Directorate General, Call to CESR for Technical Advice on Possible Measures concerning Credit Rating Agencies, page 2.

[19] CESR's technical advice to the European Commission on possible measures concerning credit rating agencies, Consultation paper, November 2004; http://www.cesr-eu.org/.

agencies (CRA).[20] The Communication is reprinted as Appendix 3 to this book for your convenience.[21] The Commission announced that it would not adopt any measures with respect to rating agencies in the immediate future, but rather, would continue to put CRAs under scrutiny:

> "It [the Commission] is confident that the existing financial service directives applicable to CRAs – combined with self-regulation by the CRAs on the basis of the newly adopted International Organisation of Securities Commissions (IOSCO) Code – will provide an answer to all major issues of concern raised by the European Parliament. The Commission will monitor developments in this area very carefully. It may consider introducing new proposals if it becomes clear that compliance with EU rules or the IOSCO Code is unsatisfactory or if new circumstances arise – including serious problems of market failure or new developments in other parts of the world."

This reticence towards further financial legislation and focus on consolidation of the existing body of law corresponds with the general policy under the new EU Commissioner Charlie McCreevy as announced in the recent policy declarations.[22] According to the White Paper on Financial Services Policy[23] "Dynamic consolidation is the *leitmotiv* of the Commission's approach." The

[20] Note to the press "Internal Market: Commission sets out its policy on credit rating agencies," January 9, 2006, IP/06/8.
[21] Communication from the Commission on Credit Rating Agencies (2006/C 5 9/02).
[22] Green Paper on Financial Services Policy (2005-2010), Text with EEA-relevance, COM (2005) 177 as of May 3, 2005 (containing the overall objective of the Commission's financial services policy over the next 5 years):
"The Commission is committed to act only where European initiatives bring clear economic benefits to industry, markets and consumers. Concretely, the Commission is currently looking into the areas of rating agencies and financial analysts, where – after having received the advice of CESR and CEBS – a decision should be made as to whether additional legislation is needed at this stage or whether the current provisions in the Market Abuse Directive as well as self-regulation and monitoring mechanisms are sufficient."
[23] White Paper on Financial Services Policy (2005-2010), SEC (2005) 1574 as of December 5, 2005.

critique by market-participants of the ever-increasing regulatory impact may have caused this "impact assessment and better regulation"-approach.[24]

Therefore, at this stage of the evolution of its financial services agenda, the EU Commission preferred not to get involved in active rulemaking. That, however, does not mean that the rating industry has been freed from the public eye; on the contrary, as EU Commissioner McCreevy put it:[25]

> "In short, the rating industry remains "on watch" and will be monitored. We may need to modify our approach in the light of non-compliance or of changing circumstances."

Despite the EU Commission's reticence, another standard-setting body of the EU has, however, filled the gap. Pursuant to the Capital Requirements Directive[26], investment firms and credit institutions may use external credit assessments to determine the risk weight of their exposures, provided the External Credit Assessment Institutions (ECAIs) that produce those assessments have been recognized as eligible for that purpose by the competent authorities. The criteria for eligibility have been summed up by the Committee of European Banking Supervisors in the "*Guidelines on the recognition of External Credit Assessment Institutions*"[27]. These guidelines are as of themselves not formally binding (but bear a persuasive authority for the interpretation of other EU law).

It may be expected that other national legislators of the EU Member States will closely mirror the CEBS pronouncement as Germany has done re-

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[24] Baums even talks of „regulatory fatigue"; Baums, Theodor, "Aktuelle Entwicklungen im Europäischen Gesellschaftsrecht", AG 2007, 57-65 [60].

[25] Note to the press "Internal Market: Commission sets out its policy on credit rating agencies," 9. January 2006, IP/06/8.

[26] The Capital Requirements Directive, comprising Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions, was published in the Official Journal on Friday 30 June.

[27] Published January 20, 2006, available at http://www.c-ebs.org/pdfs/GL07.pdf

cently (please refer to Section 7.3. Recognition of Rating Agencies under German law. If the CEBS were not followed but its recommendation supplanted by national legislation, then although IOSCO intended to standardize the applicable framework to rating agencies as a global financial industry, different national responses would distort the level-playing field formerly achieved by the IOSCO code and the Basel II framework.[28]

[28] For a UK discussion on how to implement quality criteria for the use of rating agencies, e.g. Financial Services Authority, Consultation Paper 97a, Integrated Prudential Sourcebook, Annex C: Draft Rules and guidance, June 2001, Annex 1 R "Qualifying debt securities" containing a table of the "relevant rating agencies used and the minimum rating deemed to be investment grade" (For all issuers: Moody's Investor Serivce, S&P, Fitch; For Canadian issuers: Canadian Bond Rating Service, Dominion Bond Rating Service; For Japanese Issuers: Japan Credit Rating Agency, Ltd., Japan Rating and Investment Information Inc., Mikuno & Co.). The acknowledged rating agencies apparently is more narrow than in 1998, Board Notice 478, 8 June 1998, The Securities and Futures Authority.

4. The Legal Rules of the Rating Business

This chapter is dedicated to the specificities of the legal regime governing ratings. Assuming the ratings turn out to be misleading, the issuer will already be in default and the most pertinent question will naturally relate to the issue of responsibility vis-à-vis the purchaser of the security.

The legal rules of the rating business, however, depend on the kind of rating (solicited or unsolicited) in question and on the relationship at stake. While the relationship of the issuer with the rating agency is of a contractual nature in solicited cases, the relationship between the purchaser of such security and the rating agency is not of a contractual nature. The nature of their relationship is qualified as a tort relationship in the US, whereas German courts would most probably pronounce themselves in favor of qualifying that relationship as "accessory" and thus mostly governed by principles of contract responsibility.

The dominant two rating agencies, Moody's and S&P, originated in New York and, not surprisingly, most decisions on the regulation and potential liability of rating agencies have been rendered by US courts. Therefore, in section 2 of this chapter where a more detailed discussion of the legal regime is provided, we will begin by looking at US federal law, followed by the principles of state law which are most likely considered to be authoritative in most states.

Of course, it is rather daring to speak of "US law"in such terms. Federal law (Section 5.1.) is not very explicit on the question as to the liability of rating agencies and the case law of state jurisdictions (Section 5.2.) is not binding on courts in other states. While the US legal regime as such is made up of a patchwork of Federal and State law, an overall picture is evident. Thus, if we sim-

plify in order to find some commonalities, it can be said that the US courts are most likely to be inclined to find rating agencies liable vis-à-vis an investor only in cases of abuse, but not in cases of mere negligence.

In the UK, apart from the FSMA there is no statutory law which could be applied to rating agencies. Cases have been decided both in favor and against third party tort liability for defective appraisals. The cases against such liability did, however, mostly concern auditors; so far, no case law has been reported directly concerning the potential liability of rating agencies. Thus, UK law maybe more than US or German law will start with an analysis of the facts and compare the fact pattern at hand with prior decisions. This chapter might help understand the various fact patterns, which may have to be differenciated when considering the liability of rating agencies.

Part 7 on German Law must begin with the question of applicable law due to the fact that rating agencies in many cases do indeed (try to) opt out of the otherwise applicable national law. It should be mentioned that this opting-out of national law is void of moral repercussions. It is not at all clear, for example, whether German law would, in critical cases, provide any better protection to the general investor the law in the United States. Material, substantive law might be very different, especially in its approach, but the practical outcomes are even more difficult to estimate. Many procedural issues peculiar to the US system (jury system, pleading requirements, possibility of class action, pre-trial discovery, formalities) have a significant effect on the outcome of practical cases, and the legal practitioner should be careful to take these differences into consideration when arguing or stipulating in favor of one particular regime. From a practical point of view, it does, however, make sense for the rating agencies to try to adapt to only one legal regime (that of the US) in order to achieve economies of scale.

Under German law, however, such opting-out would probably not have any effect vis-à-vis purchasers of rated bonds. Although there have, up until now, been no German cases directly covering the topic of liability, it may be expected that the German courts would find rating agencies liable to investors for mere negligence if a rating was solicited. If the rating was unsolicited, investors would, however, probably only be successful in suing a rating agency if the rating was the result of gross negligence.

In any case, since a rating contains an overt prognosis on probabilities of default, even in cases of negligence it would be very difficult indeed to prove its falsity. Since this problem of heuristics and procedural proof is not inherent to either US or German jurisdiction, chapter 7 will be dedicated to that particular question. The different approaches under German or US law should, therefore, not be overestimated, as in practice, results are likely to prove quite similar.

Rating agencies work in many jurisdictions and it is not possible to cover all the jurisdictions in one paper. In practice, of course, the US legal regulations are the most important ones from the perspective of rating agencies. The U.S. is the country with the greatest capital market by far. This is due not only to the size of its economy, but also to the degree to which it relies on the capital market in corporate refinancing. In contrast, Germany is a country that, despite recent developments, still relies heavily on bank-mediated financing. The first step in deriving a basis for comparison is to classify the various fact patterns. These fact patterns are intended to give some guidance to the reader during an analysis of US, UK and the German law.

4.1. Fact patterns

Several fact patterns have to be distinguished. A rating can be solicited, i.e. the rating agency has a contract with the issuer, and can be unsolicited, i.e. no such contract exists.

4.1.1. Solicited ratings

In the case of a solicited rating, the issuer has signed a general agreement with one of the rating agencies. Such agreements allow (among other impediments to a successful claim) complete discretion of the rating agency regarding the result and the publication of the rating. Vetter believes that prior to publication the corporation is generally allowed to respond to the rating, and that in most cases, if the corporation does not permit publication, the rating will remain confidential.[29]

There is, however, usually a hearing before the rating agencies issues the rating. Legal recourse against such a result is highly unlikely given the fact that the contract with the issuer will, as a rule, stipulate complete discretion on the part of the rating agency with respect to its results.

4.1.2. Unsolicited ratings

Alternatively, if the rating is unsolicited, the rated company has no contractual ties to the rating agency and could possibly sue the rating agency. Since no contract exists, only tort law seems to be relevant *a priori* as a basis for legal action. Often a rating issued on an unsolicited basis is less advantageous to the

[29] Eberhard Vetter, "Rechtsprobleme des externen Ratings," Wertpapiermitteilungen (*WM*), 2004, 1701 (1702).

issuer because insider information is required to reveal the higher internal value of the company. Soft factors, like the quality of management, or semi-hard factors, like the value of real options, can only be assessed through information that is in many cases not publicly available.

It has been argued repeatedly that rating agencies use unsolicited ratings to preserve old or to conquer new markets. It has also been argued that they coerce issuers into buying their rating services by punishing them with bad, unsolicited ratings, whilst implicitly offering better ratings if they were to be solicited. Part 2, II, no. 6, reference number 106 of the Basel II Framework advises, "such behavior, when identified, should cause supervisors to consider whether to continue recognizing such external credit assessment institutions, ECAI, to be eligible for capital adequacy purposes."

The interest of rating agencies in covering all issuances rests on the value of the universality and comparability of ratings. Imagine a class with 30 pupils and only 15 had grades. As a result, the credibility of the 15 grades would diminish and the market would look to other indicators of quality that could be universally applied to render all 30 pupils comparable in their performance. Similarly, rating agencies have a natural incentive to cover as much of the market as possible.

It should also be noted here that, for example, at Fitch it is company policy to only issue unsolicited ratings once the company has already covered an issuer. All rating agreements provide for observation and review by the rating agency. The term "unsolicited" can thus be called upon only when there is no connection to an existing contract with the issuer. This is the case, for example, if the issuer is about to access the capital markets and has been rated on prior occasions. If the new security is rated without a prior contract, then such a rating is unsolicited.

The view that contract law can only be applied if the specific security in question has been rated based on a contract is completely is consistent with a decision made by a United States District Court. The case concerned a dispute between an investor and Duff & Phelps, a rating company. Duff & Phelps had rated securities issued by the mother company; the daughter company, however, went bankrupt. The investor who had purchased its securities from the daughter company then tried to recover his losses from Duff & Phelps. The Court held that (even assuming such wrongful rating) no liability could be incurred for rating different securities[30]:

> "The legal (and policy) issue underlying this action is whether a securities rating service that rated securities issued by a subsidiary company can be held liable for fraud in the sale of different securities issued by the principal company, despite the fact that it did not rate those securities. At least on the facts of this case, where the Offering Memoranda disclosed that the securities in issue were not and would not be rated, the Court recommends that the Rule 10b-5 securities fraud claim be dismissed."

Several theories seem possible here, ranging from negligent misrepresentation to defamation (libel or slander) and mere negligence. In practice, it seems unlikely that the rating agency will be sued by the issuer, even in the case of an unsolicited rating, due to the fact that issuers are highly dependent on the mercy of the dominant rating agencies. Just like rating agencies, most issuers are repeat players, i.e. they always issue on the same market and permanently have to seek the acceptance of capital markets. As a result, given the oligopolistic structure of that particular market they are at the mercy of rating agencies.

[30] Re Towers Financial Corporation noteholders litigation, 1996 U.S. Dist. LEXIS 22674, 2.

Litigation against one of the dominant rating agencies could even be interpreted as an act of agression and punished severely by downgrading the issuer.

However, litigation against unsolicited ratings does, at first sight, appear to have some chance of success. Rating agencies do not indicate if the rating assigned is solicited or unsolicited. Since the vast majority of ratings are issued on a solicited basis, capital markets will tend not only to assume that the rating is solicited but also, by implication, that the rating indirectly reveals insider information that is not publicly available. The investors will, therefore, give greater credit to the rating than would otherwise be the case had they known that the rating was issued on an unsolicited basis.

4.2. The accessory relationship of investor suits to the rating agreement between issuer and rating agency

Investors suing a rating agency can also be divided into two *a priori* categories. Either they sue in connection with a solicited rating or in connection with an unsolicited rating. If they sue in connection with a solicited rating they might invoke the contractual tie existing between the rating agency and the issuer. This tie could result in a contractual liability on the grounds that the contract between the issuer and the rating agency is to the benefit of the third-party investor. Rating agencies present themselves as acting in the sole interest of the investor. Their service is to provide information to the investors. In many ways, they are comparable to other gatekeepers of the capital markets like analysts or certified public accountants who all render their services to the indirect benefit of a larger public. Contract theory may, thus, possibly be used to justify holding

rating agencies liable for the damages that investors incur when they rely, on the basis of reasonable assumptions, on a wrongful rating.

If the rating is unsolicited, investors cannot link their claim to any contract. The only theories upon which investors could possibly hold rating agencies liable in this situation would be either negligent misrepresentation or fraud. Non-tortuous theories, however, are not applicable.

These fact patterns should be kept in mind when analyzing American case law and German doctrine.

5. The Law in the United States

In the area of rating agencies, both common law principles (mostly of tort law but also of contracts) as well as securities law has to be observed. Whereas the law of torts and contracts in most instances is determined by state law, the source of securities law is mostly Federal statutory law. In litigation, both areas of law would be applied and the mélange makes up for a highly complicated area of law. Naturally, the law of the various States differs and finding common law principles governing them all must be done by way of simplification. Here, the notion of the "law of the United States" is applied to touch upon the question of liability only from the angle of Securities laws. Federal law does not conclusively decide on the matter and acts as a shield rather than as a basis for the potential liability of rating agencies. State law is covered with reference to specific cases that have been reported on the matter of liability of rating agencies. For more information on choice of law clauses under NY law, please refer to part 7.1.2. In case of a choice of law clause.

Despite the differences between the various States' laws, the attempt is made to sum-up the results to find a "Conclusion for US law"; US law here is meant to include both the angle of Federal and generally applicable common law.

5.1. Federal law

Federal law deals with rating agencies from the angle of capital markets law, which in itself often has been framed upon the basis of the Common Law on torts. The only body of law explicitly dealing with rating agencies is the "Credit Rating Agency Reform Act of 2006". This bill became law through its signing by the President ("enactment") on Sept. 29, 2006, and has been explained earlier (page 68). The bill is reprinted as Appendix 2 to this book for your convenience. The bill does not, however, explicitly deal with the issue of liability of rating agencies. In Sec. 15E 2, (m) (2) the Act provides:

> "Nothing in this section may be construed as creating any private right of action and no report furnished by a nationally recognized statistical rating organization in accordance with this section of section 17 shall create a private right of action under section 18 or any other provision of law."

The result of this paragraph is that the Credit Rating Agency Reform Act is purely a body of public law without any private right of action. Whether or not the submitted information, in particular the published policies and procedures, will be seen as having also the quality of general terms of conditions in the private law relationship between the rating agency and the issuers or investors remains to be seen. From the foregoing paragraph it is clear that at least the act as itself does not create such private rights of acts. Nor will the SEC's rules and regulations (cf. section 15E (n) of the Credit Rating Agency Reform Act) implemented in furtherance to the Act create any such private rights of action.

Nonetheless, arguably, a rating agency will not be able to deny being subjected to its own standards. If, for example, the policies and procedures of a rating agency provide that the rating analyst in charge of analyzing an issuance must not be him- or herself substantially invested or otherwise interested in the issuance, then the analysts disobedience against this proprietary standard of care will be an incident which a common law court will weigh in favor of the rating agencies liability. Conceptually, however, the basis for such action will not lie in the Credit Rating Agency Reform Act itself; it remains to be seen, therefore, which other basis for a course of action are available for a court's finding in favor of the rating agencies liability towards an investor.

5.1.1. Liability for fraudulent statements of facts under Rule 10b-5 of the Securities and Exchange Act

Rule 10b-5 of the Securities and Exchange Act of 1934[1] is probably the most important basis for suing on the grounds of capital market fraud.[2] The condition of "using any instrumentality of interstate commerce" is intended to serve as a constitutional hook to allow for federal jurisdiction. In the parts most relevant to this work, the Rule reads:

> "It shall be unlawful for any person… to make any untrue statement of a material fact…"

If such a statement leads to damages, in principle, the person harmed may sue the author of the fraudulent statement for the damage caused thereby. From this statute the courts have inferred a private damages action,[3] "which resembles, but is not identical to, common-law tort actions for deceit and misrep-

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[1] Section 10b of the Securities and Exchange Act enabled the SEC to enact rule 10b-5 on "Manipulative and deceptive devices and contrivances":
Rule 10b-5 Employment of Manipulative and Deceptive Devices
"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or any facility of any national securites exchange,
(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act practice, or course of business which operates or would operate as a fraud or deceit upon any person."

[2] The prevailing view on § 17(a) of the Securities Act is that this provision is criminal in character and does not prevail private rights of action, cf. Rainer Schmitz, "Die Haftung des Vorstands gegenüber den Aktionären, Eine rechtsvergleichende Untersuchung nach deutschem und US-amerikanischem Recht," *Frankfurter wirtschaftsrechtliche Studien*, vol. 62, 2003, 99.

[3] The first recognition by a federal court was implicit, *Kardon v. National Gypsum*, 69 F. Suppl. 512 (E.D. Pa. 1946); the Supreme Court first explicitely recognized a private right of action as late as 1971 (*Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). The history of 10b-5 is very well explained by Knut Sauer, "Haftung für Falschinformation des Sekundärmarktes, " (PhD Diss, Frankfurt 2004), 100 et seq..

resentation."[4] In the Dura Pharmaceuticals case, the US Supreme Court again specified the conditions of an action under Rule 10b-5; to ensure completeness the full quote is given:

> "In cases involving publicly traded securities and purchases or sales in public securities markets, the action's basic elements include:
> (1) a material misrepresentation (or omission) see *Basic Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988);
> (2) scienter, i.e., a wrongful state of mind, see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, at 197, 199;
> (3) a connection with the purchase or sale of a security, see *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, at 730-731,
> (4) reliance, often referred to in cases involving public securities markets (fraud-on-the-market cases) as "transaction causation," see Basic, supra at 248-249 (non-conclusively presuming that the price of a publicly traded share reflects a material misrepresentation and that plaintiffs have relied upon that misrepresentation as long as they would not have bought the share in its absence);
> (5) economic loss, 15 U.S.C. section 78 u-4 (b)(4); and
> (6) "loss causation," i.e., a causal connection between the material misrepresentation and the loss, ibid; cf. T. Hazen, Law of Securities Regulation, §12.11[1], [3] (5th ed. 2002)."

Ratings are, however, not generally statements of a fact (condition no. 1). They convey information about the creditworthiness of an issuer, but a rating as such is merely an opinion, not a statement of a fact. Only in certain instances may a rating contain a truly factual statement. Imagine, for example, an issuer in financial difficulties. If in such a situation an investment grade rating is obtained, then this rating may contain a factual statement to the effect that the conditions for the beginning of insolvency proceedings are not met. As Rogers puts it:

[4] Decision of the Supreme Court of the United States, *Dura Pharmaceuticals, Inc., et. al., petitioners v. Michael Broudo et al*., 544 US (2005), No. 03-932 as of April 19, 2005, 4.

> "A statement of opinion frequently carries within itself a statement of fact."[5] In particular, Rogers points out that:
> "Often also an expression of opinion carries the implication that the person expressing it has reasonable grounds for it, and where this is not the case he may be guilty of a misstatement of a fact."[6]

Oellinger even argues that ratings deduced by purely mathematical means without any subjective criteria would "evidently" qualify as statements of fact.[7] Personally, I do not concur. Even the selection of purely quantitative criteria implies a judgment on the issuer's relative importance and should thus be protected by the provisions applicable for opinions rather than for statements of fact. The underlying statistical components would qualify as statements of fact, but these are not disclosed by the rating agency. In the majority of cases the rating is therefore not considered a statement of fact.

In the case of rating agencies, which claim to be professional experts in their field, accompanying each rating is the implicit assertion that a rating analyst had reasonable grounds upon which to base his inferences and carried out the necessary steps customary to the industry to arrive at his conclusion without colluding with the issuer. In so far, a rating is – except in extraordinary cases in which the rating conveys additional factual assertions on the issuer – also a factual statement and may make the author of such a statement subject to common law or statutory rules for misleading statements. In general, however, Rule 10b-5 of the Securities and Exchange Act of 1934 cannot be applied as a basis for liability.

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[5] W.V.H. Rogers, *Winfield and Jolowicz on Tort*, 15th ed., (Sweet & Maxwell, London 1998), 355.
[6] W.V.H. Rogers, *Winfield and Jolowicz on Tort*, 15th ed., (Sweet & Maxwell, London 1998), 356.
[7] Gerhard C. Oellinger, "Juristische Konsequenzen bei fehlerhaften Ratings und mögliche Lösungsansätze, " in *Grundlagen und Implikationen von Ratings für Agenturen, Investoren und geratete Unternehmen,* eds. Ann-Kirstin Achtleitner and Oliver Everling, 357-389, 362

Factual statements may be as inaccurate as positive assertions (*suggestio falsi*) or omissions and half-truths (*suppressio veri*)). [8]

5.1.2. Fraud on the market-theory and the presumption of reliance

If the plaintiff can prove that a factual statement has been made by the rating agency, and that the statement in question was wrongful and material, he is still required to prove the causality between the harm endured and the statement. In this context, even further differentiation may be made with respect to causality: the plaintiff has to prove that the false factual statement caused him/her to buy or sell the security (invoking causality between the wrongdoing and the victim's reaction); and he/she also has to prove the causality between the wrongdoing and the actual damage (loss causation). Actions on grounds of statutory and common law torts will always lead only to the repair of the situation prior to the fraudulent action (under German law called the "negative interest"), and not lead to the reparation of the eluded gains (under German law called the "positive interest"). [9]

To achieve the proof of causation, it might, in principle, be supposed that individual reliance on the statement would have to be shown. However, this would be virtually impossible. In a capital markets transaction buyers and sellers of securities do not typically communicate with one another, or if they do, then only by electronic means. Thus, individual reliance would be an insurmountable element.

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[8] W.V.H. Rogers, *Winfield and Jolowicz on Tort*, 15th ed., (Sweet & Maxwell, London 1998), 357.
[9] Cf. for English law, W.V.H. Rogers, *Winfield and Jolowicz on Tort*, 15th ed., (Sweet & Maxwell, London 1998), 362.

In practice, the courts do not require a demonstration of individual reliance.[10] In efficient markets,[11] most investors are price takers and not price makers. They rely on the integrity of the pricing mechanism to process all material and available data. As the Supreme Court put it:[12]

"Who would knowingly roll the dice in a crooked game of craps?"

If such data is factually wrong, then the courts will presume that the markets have processed that information for the pricing mechanism and that the investor, thereby, indirectly relied on the information. This idea is called the "fraud-on-the-market theory":

> "The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price … is determined by the available material information regarding the company and its business… Misleading statements will therefore defraud purchasers … even if the purchasers do not directly rely on the misstatements … The causal connection between the defendants' fraud and the plaintiffs' purchase … in such a case is no less significant than in a case of direct reliance on misrepresentations."[13]

[10] The standard for this case-law has been set by Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975)

[11] For a more detailed description of the various forms of markets under the efficient market hypothesis (weak – all information contained in the historic markets rates is resembled by current markets prices, semi-strong – all publicly available information is resembled by the current market prices, strong efficiency – all information, being publicly available or insider knowledge, is resembled by current market prices), cf. Rainer Schmitz, "Die Haftung des Vorstands gegenüber den Aktionären, Eine rechtsvergleichende Untersuchung nach deutschem und US-amerikanischem Recht," *Frankfurter wirtschaftsrechtliche Studien*, vol. 62, 2003, 82.
The predominant view of capital markets in developed countries is that market efficiency is semi-strong justifying reliance on prices as a resemblance of all publicly available information.

[12] *Basic v. Levinson*, 485 U.S. 224, 247 (1988), by reference to *Schlanger v. Four-Phase Systems Inc.*, 555 F. Supp. 535, 538 (SDNY 1982).

[13] *Peil v. Speiser*, 806 F. 2d 1154, 1160-1161 [CA3 1986].

The fraud-on-the-market theory, while having been developed for actions founded on Rule 10b-5,[14] is also applicable to acts of fraud under the principles of common law.[15] In the famous ruling of Basic, Inc. v. Levinson[16] the Supreme Court clarified that the fraud-on-the-market theory would, in practice, lead to a presumption of reliance on all publicly available material information. That presumption can be refuted if the defendant proves that the misleading information has not influenced the market price, or if the plaintiff in the individual case at hand has not relied on the correctness of the market price.[17]

The fraud-on-the-market theory thus establishes a presumption of reliance[18] if the plaintiff alleges and proves:

1. that the defendant made public misrepresentations;
2. that the misrepresentations were material;
3. that the shares were traded on an efficient market;
4. that the misrepresentations would induce a reasonable and reliable investor to misjudge the value of the shares; and
5. that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.

The contours of the fraud-on-the-market theory were recently restricted dramatically by the Dura Pharmaceuticals case. Proceedings in both federal state courts follow two phases: the preliminary phase of pre-trial discovery and the trial phase in which the evidence is presented to a jury and the jury makes a

[14] An important case in this development is *Blackie v. Barrack*, 524 F. 2d at 891 (9th Cir. 1975).
[15] Rainer Schmitz, "Die Haftung des Vorstands gegenüber den Aktionären, Eine rechtsvergleichende Untersuchung nach deutschem und US-amerikanischem Recht," *Frankfurter wirtschaftsrechtliche Studien,* Volume 62, 2003, 80.
[16] US Supreme Court, *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).
[17] Rainer Schmitz correctly points out that the option to refute the presumption is of a rather theoretical nature, cf. "Die Haftung des Vorstands gegenüber den Aktionären, Eine rechtsvergleichende Untersuchung nach deutschem und US-amerikanischem Recht," *Frankfurter wirtschaftsrechtliche Studien*, vol. 62, 2003, 84.
[18] James D. Cox, Robert W. Hillmann, Donald C. Langevoort, *Securities Regulation, Cases and Materials,* 3rd ed., Aspen Law & Business, (New York 2001), 774 et seq.

decision based on the facts. The first phase marks the period in which the professional judge has the greatest influence. He will only summon a jury if all the requirements for jurisdiction are met and if the plaintiff's allegations on a standalone basis support the court's finding in favor of the plaintiff. Securities litigation, in practice, is very much connected to class actions and the courts are cautious about allowing such proceedings to go to trial. Thus, although the US Supreme Court "concedes that the Federal Rules of Civil Procedure require only a short and plain statement of the claim showing that the pleader is entitled to relief," it finds that "the short and plain statement must provide the defendant with fair notice of what the plaintiff's claim is and the grounds upon which it rests."

In Dura Pharmaceuticals, the plaintiff alleged that the share price was inflated at the time of purchase due to misrepresentations about the prospects of a spray device by the Food and Drug Administration, but had already fallen significantly before the alleged misrepresentation became publicly known. The Supreme Court concluded that the artificially inflated purchase price did not in itself constitute a relevant economic loss. Otherwise, this would "permit a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the discovery process would reveal relevant evidence." It argued: "such a rule would tend to transform a private securities action into a partial downside insurance policy."

This ruling is significant not only in the sense that it raises the requirements for a successful proof-of-loss causation in inflated price fact patterns, but also in the context of a common law tradition where the filing of a law suit is

usually considered as simply serving the purpose of informing the defendant of the grounds for a legal action and the factual and legal allegations.[19]

In the civil code tradition, a professional judge generally decides both on the admissibility of evidence and on the facts themselves, and is keen to scrutinize all legal actions for compliance with formal requirements. Typically, this requires a detailed allegation of facts already containing proposals in order to secure evidence in case the facts become, at some point, subject to dispute.

5.1.3. The pleading with particularity requirement

The Dura Pharmaceuticals case follows a tradition of cases that insist on a pleading with particularity. In practice, courts have, on many occasions, insisted that scienter of the author of a fraudulent statement be proven with particularity. One of the latest developments in this regard is the Enron case.

On December 19, 2002, the United States District Court for the Southern District of Texas, Houston Division (235 F. Supp. 2d 549) decided on several motions to dismiss the pending Enron litigation. In a class action filed on behalf of purchasers of Enron Corporation's publicly traded equity and debt securities, the Court had to decide on the motion to dismiss by several banks, law firms and accounting firms. The main procedural obstacle to actions for fraud is often the requirement to plead fraud with particularity. The Federal Rules of Civil Procedure provide in Section 9b that:

> "(i)n all averments of fraud or mistake, the circumstances constituting fraud or error shall be stated with particularity. Malice, intent, knowledge, and other conditions of mind of person may be averred generally."

[19] This observation stems from Siegfried H. Elsing, "Trauben für Aktionärsklagen in den USA höher gehängt, Geschädigte Investoren müssen direkten Zusammenhang zwischen falscher oder unterlassener Information und Schaden nachweisen," *Börsen-Zeitung*, June 29, 2005, 2.

A similar provision is contained in section 21D(b)(2) of the Securities Exchange Act, which was stipulated by the Private Securities Litigation Reform Act.[20] Given the anonymous nature of capital markets and the lack of personal communication, this requirement generally imposes a difficult burden on plaintiffs.

The court in the Enron case lowered that burden somewhat. It argued that the pleading requirement would be satisfied if a regular pattern of fraudulent conduct could be alleged and if facts about the specific involvement of each defendant were made:[21]

> "As a factor common to all, the Court initially finds that the scienter pleading requirement is partially satisfied by allegations of a regular pattern of related and repeated conduct[22] involving the creation of unlawful, Enron-controlled SPEs, sale of unwanted Enron assets to these entities in clearly non-arm's length transactions and often with guarantees of no risk, in order to shift debt off Enron's balance sheet and sham profits onto its books at critical times when quarterly or year-end reports to the SEC, and by extension the public, were due, followed in many cases by the undoing of these very deals once the reports had been made. These transactions were not isolated, one-of-a-kind instances of violations of the statutes, but deliberate, repeated actions with shared characteristics that were part of an alleged common scheme through which Defendants all profited handsomely, many exorbitantly….
> Nevertheless, without some particular facts about specific involvement of each Defendant in fraud[23] that would alert a reasonable party to recognize its participation in a fraudulent scheme (…), such general allegations applied to every Defendant across the board are not sufficient by themselves to raise a strong inference of scienter."

[20] Reference is made to Rainer Schmitz for the effects of that pleading requirement under the securities laws, "Die Haftung des Vorstands gegenüber den Aktionären, Eine rechtsvergleichende Untersuchung nach deutschem und US-amerikanischem Recht," *Frankfurter wirtschaftsrechtliche Studien,* vol. 62, 2003, 90-91.
[21] 235 F. Supp. 2d, 694.
[22] Emphasis added.
[23] Emphasis added.

By consequence, under American law to date, an investor suit based on a fraudulent statement seems possible in cases where a rating contains a statement and where a fraudulent pattern can be alleged. Even if these conditions are proven, doubts remain, however, as to whether an investor suit based on mere negligent misrepresentation can be successful.

5.1.4. Rule 436(g)(1) of the Securities Act of 1933

In the US, section 11[24] of the Securities Act of 1933 provides the general form of prospectus liability for all persons who share in the responsibility for an untrue statement of a material fact in relation to a registration statement. Rule 436(g)(1) of the Securities Act of 1933 states:

> "Notwithstanding the provisions of paragraphs (a) and (b) of this rule, the security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock by a nationally recognized statistical rating organization, or with respect to registration statements on Form F-9 by any other rating organization specified in the Instruction to paragraph (a)(2) of General Instruction I of Form F-9, shall not be considered a part of the registration statement prepared or certified by a person within the meaning of sections 7 and 11 of this Act."

[24] "In case any part of the registration statement, when such a part became effective, contained an **untrue statement of a material fact** or omitted to state a material fact required to be stated therein or necessary to ensure that the statements therein were not misleading, **any person acquiring such security** (unless it is proved that at the time of such acquisition he knew of such untruth or omission) **may**, either at law or in equity, in any court of competent jurisdiction, **sue** –

...

(4) **every** accountant, engineer, or **appraiser**, or any person **whose profession gives authority to a statement made by him**, **who has with his consent been named** as having prepared or certified any part of the registration statement, or **as having prepared** or certified **any** report or **valuation which is used in connection with the registration statement**, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

…"

Federal law thereby privileges Nationally Recognized Statistical Rating Organizations (NRSROs) from prospectus liability for assigned ratings. Such privileges in favor of only certain NRSROs increases market concentration among rating agencies. Until recently, there were only three NRSROs – Moody's, Standard & Poor's and Fitch. On February 24, 2004, the SEC approved a fourth NRSRO, Dominion Bond Rating Limited.[25]

While perhaps warranted to increase the independence of rating agencies, the repercussions of the NRSRO recognition/registration are comparable to those of an oligopoly franchise authority. New rating agencies are effectively blocked from the market by the risk of prospectus liability, while the existing market participants are effectively shielded both from liability and from market pressure. It remains to be seen whether the new registration system is able to increase competition.

5.1.5. The First Amendment

Some courts see the First Amendment as a shield to the potential liability of rating agencies. Some courts have decided that ratings are privileged free speech under the First Amendment. Other courts have deemed ratings to be "opinions" and therefore protected speech under the First Amendment.[26] For example, in *County of Orange v. The McGraw-Hill companies*, Orange County

[25] Dominion Bond Rating Serv. Ltd., SEC No-Action Letter (Feb. 24, 2003), http://www.sec.gov.divisions/marketreg/mr-noaction/dominonbond022403-out.pdf.

[26] Cf. *Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc.,* 988 F. Supp. 1341, 1348 (D. Colo 1997), aff'd, 175 F.3d 848 (19th Cir. 1999) (holding that Moody's unsolicited rating of the plaintiff's bond issue was merely an opinion, and protected expression under the First Amendment).

sued S&P's Ratings Services alleging that S&P had wrongfully estimated the default risk of Orange County.

The United States District Court[27] ruled that S&P's ratings were published speech on a matter of public concern and therefore protected by the First Amendment. The ratings could be the basis of liability only if Orange County proved with clear and convincing evidence that S&P had acted with actual malice, i.e. that S&P had knowledge that the ratings were false or had reckless disregard for their truth or falsity. The Court restricted its holding to the particular fact pattern of the issuer suing the rating agency:

> "The Court does not address whether this analysis would apply if the plaintiff were an investor who received the ratings through the media."

Following this ruling, the Ninth Circuit Court of Appeals refused to permit an expedited appeal and in June 1999, Orange County agreed to dismiss its over $2 billion lawsuit against S&P in exchange for the nominal sum of $140,000; a partial refund of rating fees paid by Orange County during 1994.

In *Compuware Corporation v. Moody's Investor Services*,[28] the Court found the decision on County of Orange v. McGraw-Hill Companies to be "persuasive." It concluded:

> "Therefore, in order to prevail on the breach of contract claim, Plaintiff must show that Defendant acted with actual malice or reckless disregard of the truth while performing the contracted-for services."

[27] Central District of California Case No. SACV 96-0765 = 245 B.R. 151, 154 (C.D. Cal 1999).
[28] United States District Court for the Eastern District of Michigan, Southern Division, *Compuware Corporation v. Moody's Investor Services,* decided June 10, 2004, Case Civil No. 03-70247, 2004 U.S. Dist. LEXIS 1061.

5.1.6. Conclusion on the standards of federal law

Imagine that an action is brought against a rating agency under common law principles or Rule 10b-5. While it is quite conceivable that the plaintiffs prove their reliance by referring to the fraud-on-the-market theory, at least under Rule 10b-5 the courts require "scienter." The vast majority of circuit courts have also recognized that recklessness would be treated as fulfilling the scienter requirement. However, in the words of the 7th Circuit Court of Appeals in *Sunstrand Corp. v. Sun Chemical Corp.* (553 F.2d 1033, 1045):

> "Reckless conduct may be defined as … highly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[29]

The passage evokes a threshold that is almost impossible to pass. While this threshold is well established for actions under Rule 10b-5, even outside the scope of this rule the First Amendment was, it seems, interpreted by the US District Court in *County of Orange v. The McGraw-Hill companies* [30] as requiring such an increased demonstration of fault. Thus, in order to win their case, plaintiffs will have to pass a very difficult test.

Federal law severely limits any potential liability of rating agencies for their ratings. Although offering a broad basis for liability and exempting the plaintiff from proving individual reliance, federal law still effectively restricts liability to clear-cut cases of abuse. It is almost impossible to show that a rating

[29] Rainer Schmitz points out that recklessness is therefore more than some severe form of negligence ("grobe Fahrlässigkeit"), "Die Haftung des Vorstands gegenüber den Aktionären, Eine rechtsvergleichende Untersuchung nach deutschem und US-amerikanischem Recht," *Frankfurter wirtschaftsrechtliche Studien*, vol. 62, 2003, 89.
[30] Central District of California Case No. SACV 96-0765 = 245 B.R. 151, 154 (C.D. Cal 1999).

is not connected to a prospectus, that it contains a factual statement, that it was rendered with malice or reckless disregard for the truth, and to plead such fraud with particularity.

5.2. State law

Of course, many concepts used in the context of US case law on torts are quite similar (especially the idea of *stare decisis*) to the common law concepts of English law, which will be examined at a later stage. However, with respect to its capital market law, the US may be the more mature system, thus perhaps deserving an earlier position in the analysis.

It is beyond the scope of this analysis to examine all aspects of the laws of the various states pertaining to our subject. In this context, however, the law of New York and the law of Illinois have been the subject of litigation. The analysis will therefore limit itself to these two states.

Most state courts applying common law principles would probably find mere negligence to be an insufficient basis for the legal action of third parties against a rating agency. In *Ultramares v. Touche,*[31] a case concerning an action against a certified chartered accountant, the NY Court of Appeals argued that the accountant only owed a duty of care towards the issuer to whom he had rendered his services. Liability would thus remain conceivable under negligence only if the agreement conferred on the user of certified financial data an individual right of action. Generally, however, such privity is considered to be deficient vis-à-vis third parties.

[31] *Ultramares Corp. v. Touch, Niven & Co.*, 255 N.Y. 170 N.E. 441, 444-49 (1931).

The grounds for an investor's action would thus, in all likelihood,[32] rather be that of negligent misrepresentation. This, however, brings the action into potential conflict with the First Amendment.

5.2.1. New York Press Shield

The State of New York has promulgated a so-called Press Shield Law that contains certain privileges for journalists such as freedom from having to produce documents in discovery proceedings.

The Court of Appeals for the Second Circuit found that given the facts at hand Fitch could not assert the NY statutory newsgathering privilege that is codified in the NY's Press Shield Law. The underlying facts were somewhat complicated. In a litigation case pending in the District of Hawaii, a request for a non-party subpoena to produce documents was made to Fitch Inc. That request was addressed to the United States District Court for the Southern District of New York. As Fitch did not comply with the subpoena, the District Court for the Southern District of New York found Fitch in contempt of justice for its refusal to comply. Fitch appealed alleging that NY's Press Shield Law protected it.

The US Court of Appeals for the Second Circuit compared Fitch to a journalist and found Fitch not to be similar. It found that unlike journalists, Fitch only covered its own clients. It argued that the client initiated the vast majority of ratings and an exchange of confidential information would, therefore,

[32] The privity standard of Ultramares is heavily disputed in US doctrine and among State courts. Other courts prefer to limit exposure to liability to foreseeable third persons or follow section 522(1) of the Restatement (Second) of Torts. For a more detailed analysis of the dispute, cf. Wessel Heukamp, "Brauchen wir eine kapitalmarktrechtliche Dritthaftung von Wirtschaftsprüfern?," *ZHR* 169, 2005, 471-494 (482-483).

typically precede a rating. Therefore, the profession of a rating agency is not comparable to that of a journalist. On these facts the Circuit court concluded:

> "Taking these two factors together, we conclude that the district court did not abuse its discretion in finding that Fitch was not entitled to assert the journalist's privilege for the information at issue."

The Circuit Court, however, thought it could leave the general question open:

> "For the sake of clarity, we note that we are not deciding the general status of a credit rating agency like Fitch under New York's Shield Law: Whether Fitch, or one of its rivals, could ever be entitled to assert the newsgathering privilege is a question we leave for another day… We simply conclude that on these facts, the district court did not abuse its discretion by concluding that Fitch had not sufficiently shown that the information it sought to protect was gathered pursuant to the newsgathering activities of a professional journalist."

Despite that obiter dictum, the courts would most probably not apply the NY Press Shield Law to other cases involving rating agencies. This somewhat contradicts the findings regarding the First Amendment analysis (rating agencies benefit from protection) but NY statutory law seems to be more limited in its effects. Procedurally, it may thus be argued that NY will probably not shield rating agencies by applying the NY Press Shield Law.

5.2.2. The limited scope of the 7th Circuit Decision Quinn v. McGraw-Hill Company

The case that relates most precisely to the issue of rating agency liability is probably the Seventh Circuit decision *Quinn v. McGraw-Hill.*[33] An individual investor attempted to sue S&P for negligent misrepresentation and breach of contract for an investment that was initially A rated, then downgraded to CCC and defaulted soon afterwards.

The litigation had initially been brought before a State court in Illinois, but was then dismissed to federal courts on the grounds of diversity of citizenship. The Federal Court of Appeals thus had to rule on the case as if it were a matter under Illinois jurisdiction. On the contract claim the Seventh Circuit thus referred to the case law of Illinois: [34]

> "The Supreme Court of Illinois has explained that "Illinois follows the intent to benefit rule; that is, third-party beneficiary status is a matter of divining whether the contracting parties intended to confer a benefit upon a nonparty to their agreement…
> At the same time, Illinois has made it very difficult to prove intent to benefit the third party, because "there is a strong presumption that parties to a contract intend that the contract's provisions apply to only *them* and not to their parties… Express language in the contract identifying the third-party beneficiary is the best evidence of intent to benefit that party, but the courts have also accepted an implied showing where the implication that the contract applies to third parties is so strong as to be practically an express declaration. …
> In Our view, an Illinois court would find this insufficient as a matter of law to state a claim for breach as to a third-party beneficiary. … Quinn has underestimated the direct value of a rating to the issuer. Once the issuer knows the rating its instruments will earn, it has a better idea of which customers are likely to be interested, what interest rate (or other

[33] *Quinn v. McGraw-Hill*, 168 F.3d 331 (7th Cir. 1999).
[34] *Quinn v. McGraw-Hill*, 168 F.3d 331 (7th Cir. 1999), 334-335.

> elements of price) to attach to the placement, and where it stands relative to others in its line of business. In short, this is a perfectly reasonable – perhaps even indispensable – contract for AHAC [the issuer] to have entered for its own purposes. Contracts between two parties often generate information that is valuable to third parties …"

On the tort claim for negligent misrepresentation, the Seventh Circuit characterized reliance on the S&P rating as "unreasonable" given the particular facts of the case. The relevant part[35] in the decision reads as follows:

> "At the same time Quinn found out that the bonds had indeed been rated 'A', he received the letter from RPR [the issuer] informing him that subtantial risks were involved in this type of investment. The same letter cautioned that a S&P rating was "not a recommendation to buy, sell, or hold any such Bonds and may be subject to revision or withdrawal at any time." … In addition to these explicit statements, which should have alerted Quinn to the fact that he was responsible for doing his own homework about the risks he was assuming, Quinn himself (an experienced banker) knew as of March 1993 from a letter AHAC had sent him that over $1 million of the mortgage loans were more than 30 days delinquent, the reserve fund balance was only $131,051, and the FHA Title I Insurance balance was $600,385. Quinn chose to take no action at that time; indeed, he let matters ride for a long time, until after S&P had downgraded its own rating.
> In light of these facts, no reasonable jury could find that Quinn reasonably relied on S&P's evaluation the quality of the bonds. At best, he might have hoped that the bonds would retain a higher market value that they should have had for some period of time, until the true facts came out. … While it is unfortunate that Quinn lost money, and we take him at his word that he would not have bought the bonds without the S&P 'A' rating, any reliance he may have placed on that rating to reassure himself about the underlying soundness of the bonds was not reasonable."

[35] *Quinn v. McGraw-Hill,* 168 F.3d 331 (7th Cir. 1999), 336.

From these quotes it is apparent that the Quinn case concerned a very particular fact pattern. Quinn was an experienced banker. A letter from the issuer had informed him that over $1 million worth of the mortgage loans were more than 30 days delinquent. Under such circumstances, reliance even upon an evaluation by S&P did indeed seem unreasonable.

Furthermore, its precedent is persuasive only for courts within the Illinois jurisdiction. If a new case had to be decided according to another state's law, where the presumption against third party beneficiary law did not exist, that new court might decide otherwise. Also, if an unsophisticated investor relied on a wrongful representation by one of the major rating agencies without any further insight into the financial situation of the issuer, that new court might decide otherwise. The Quinn case is, therefore, not persuasive in more typical fact patterns in which an unsophisticated investor relied on a wrongful rating.

Nevertheless, the Quinn case does show that American courts are reluctant to assume a potential liability on grounds of (contractual) third party beneficiary law. Thus, it seems adequate to focus entirely on tort principles with regard to the potential liability of rating agencies under "American" law.

5.2.3. Negligent Misrepresentation and Negligence

All States recognize some form of liability for negligent misrepresentation. Its *prima facie* conditions are:

1. Misrepresentation by the defendant in a business or professional capacity
2. Breach of duty toward a particular plaintiff
3. Causation
4. Justifiable reliance
5. Damages

Under such tort principles, however, the constraints of Federal law have to be observed once again. In this context, the most imminent protection lies in protection by the First Amendment. As a result, malice will thus have to be clearly demonstrated.

Malice is the knowledge that a statement was false or that there was reckless disregard as to its falsity. The burden resting on the plaintiff will thus effectively preclude any successful claim for damages.

The general tort of negligence would also be a suitable basis for action against a rating agency. In a litigation case against an accountancy firm, *Ultramares v. Touche*,[36] the court decided that the auditors owe a duty of care only to the person to whom they are bound by a contract. A liability of the auditor on the basis of negligence would, in this analysis, only be conceivable if the accountant and the company to be audited had specifically stated that the user of the financial data would receive the audited accounts including the auditing report as a third party beneficiary. Such privity, however, was otherwise denied.

[36] *Ultramares v. Touche, Niven & Co.,* 255 N.Y. 170 N.E. 441, 444-49 (1931); for a more thorough analysis cf. Wessel Heukamp, "Brauchen wir eine kapitalmarktrechtliche Dritthaftung von Wirtschaftsprüfern?," *ZHR* 169, 2005, 471-494.

5.3. Conclusion for US law

Case law and Statutory law both show a reluctance to find rating agencies liable. Quite to the contrary, it seems as though the courts are even willing to shield advisors from liability if they have relied on ratings by NRSROs. In *George T. Glennie v. Abitibi-Price Corp*, 912 F. Supp. 993, (W.D. Mich. 1996), the Federal District Court of the Western District of Michigan stated:

> "[E]ven though the ratings of Standard & Poor's and Moody's are not determinative of prudence per se, they are significant factors in deciding whether an investment is prudent."

Investment advisers are thus also reluctant to "try out" other rating agencies because this would increase their own burden of potential liability. Having the indices of Moody's and S&P ("S&P 500") at hand, investment fund managers therefore fare best when they mimic these indices.[37]

Nevertheless, as seen before, the Chicago Seventh Circuit Court has deemed reliance on a rating to be unreasonable given the particular fact pattern at hand. The risks of liability under US law seems extremely limited to cases of abuse (malice or recklessness); mere negligence will not be sufficient to render rating agencies liable under US law.[38]

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[37] Claire Hill, "Regulating the Rating Agencies," presented at the American Law & Economics Association Annual Meeting, 2004, Paper 1, *Georgetown University Law Center, Business, Economics and Regulatory Policy, Working Paper*, N° 452022, page 62.

[38] Cf. Iain MacNeil, *An Introduction to the Law on Financial Invesment*, (Oxford: Hart Publishing, 2005), 346. MacNeil draws draws a similar conclusion,: "In the US, the courts have held that in order for liability to be attached to a rating agency, it must be shown that they acted recklessly and not simply negligently."

6. UK Law

6.1. On the development of the financial market in the UK

The order of this country-specific analysis (US, UK and German law) aims to reflect the history of the evolution of the rating industry. The first rating companies, S&P and Moody's, were set up in the US, and Fitch in the UK. Germany, however, only relatively recently adopted the characteristics of a capital market-based system. Traditionally, Germany has had a bank-mediated financing system and to a large extent this system still prevails.[39]

Banking law in the US is governed by state law and by SEC guidance. The accumulation of rules and regulations over the years has led to the off-shoring of investment banking business to overseas, in particular to London. The Eurodollar market, i.e. the dollar-denominated bond market outside of the US, was primarily driven by intent to avoid US banking laws. As a result London became the global center of financial innovation during the last decades of the 20th century. US investment banks like Goldman Sachs, Morgan Stanley, JP Morgan, Lehman Brothers, etc. currently receive, in all likelihood, as much, if not more business from their London operations than from those in New York. It is this economic background that lends particular importance to UK law in the rating agency world. The Alternative Investment Market of the London Stock Exchange in 2005 saw more Initial Public Offerings than NASDAQ.

[39] The result of such a bank-mediated financing system was a complicated layer of cross-holdings with banks – particularly Deutsche Bank and Allianz – serving as industrial-holding companies in addition to their traditional financing function (leading to what is often referrred to as the "Deutschland AG"). Werner Seiffert , a major player in the evolution towards capital market-based capitalism was forced to step down as CEO of Deutsche Börse Group (the German exchange in Frankfurt) in May 2005 as a result of the pressure by hedge fund investors initiated by the UK's Chris Hohn's TCI ("The Children Investment – fund").

Similarly, securitizations and bond issuances are now increasingly run from London rather than New York. Ratings are but a side effect of this evolution and the London branches of rating agencies have become more powerful as a result.

6.2. The sources

Rating agencies in the UK have to comply with (mostly statutory) capital markets law to the extent it is applicable to them. The UK has implemented the Capital Adequacy Directive and the Banking Directive by way of regulation, thus now defining the criteria for recognition of rating agencies in *Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)*, section 3.6 on the *Use of rating agencies' credit assessments for the determination of risk weights under the standardised approach to credit risk.*
As of April 12, 2007, Moody's, S&P and Fitch have satisfied the requirements of the SFA.[40] Recognition has, however, only partially regulated the rating industry in the UK. The parameters for (potential) liability of rating agencies are also in UK, however, still based on the principles of common law.

Unlike the US, the UK does not have a written constitution. Defending one's right to freedom of speech can thus not be based on constitutional arguments; rather, its defense and protection constitute only a consideration of the inherent limitations of a common law based action. UK capital markets law is an interesting mélange of common law roots, original UK statutory law, and EU influence. In its common law roots, in the common law systems of contracts and torts in particular, law in the UK somewhat resembles law in the US.

[40] FSA, CRD Implementation Bulletin – Banks and building societies, Issue 6. http://www.fsa.gov.uk/pubs/international/CRD_bulletin6_bank.pdf

6.3. The rule of precedent

To a reader educated in the common law, the rule of precedent may seem self-explanatory. In other systems, however, especially the code-based systems in France or Germany, case law is seen quite differently. In code-based systems, (exceptions apply to decisions by specialized constitutional courts) decisions are generally binding only *intra partes* (as between the parties) and not *erga omnes* (with respect to all others). A lower court may thus, without contravening "the law," pass a ruling contrary to a precedent that has been set by a higher court; in practice, however, a lower court, even in a code-based system, will usually follow the higher court's reasoning in order to avoid its decision being reversed at a later date by a higher instance.[41]

Under common law, however, every court, in principle,[42] is bound to follow the *ratio decidendi*[43] of precedent decisions by a court with greater authority as long as the facts of the case are similar, the decision has not been

[41] To avoid confusion for the reader familiar with a common law system, it should be pointed out that of course, code based systems also know case law and the judiciary also has an important role in the development of the law. The understanding of case law precedents is, however, conceptually different.

[42] Dieter Blumenwitz, *Einführung in das anglo-amerikanische Recht*, 6th ed., (München; Beck Verlag, 1998), § 3, 27. *Stare decisis* is not a clear-cut rule; cf. for the US understanding of *stare decisis,* the dissenting opinion of Justice Brandeis in *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406-408 (1932): "*Stare decisis* is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right. … This is commonly true even where the error is a matter of serious concern, provided correction can be made by legislation. But in cases involving the Federal Constitution in which correction through legislative action is practically impossible, the court has often overruled its earlier decisions. The Court bows to the lessons of experience and the force of better reasoning, recognizing that the process of trial and error, so fruitful in the physical sciences, is appropriate in the judicial function."

[43] *Ratio decidendi* and "holding" are often understood as synonymous concepts, Dieter Blumenwitz*, Einführung in das anglo-amerikanische Recht*, 6. Edition, (München: Beck Verlag, 1998), § 3, 35.

modified by the same court or a court of still higher authority, and as long as statutory law does not state otherwise (*stare decisis et non quieta movere*).[44] If the facts are not similar, the court is not bound and a court may find that its particular facts merit a deviation ("distinguish on the facts"). Each precedent has thus – *a priori* – binding value *erga omnes*, but in the eyes of a common law jurist the facts are as important as the rule of law. *Stare decisis* only applies to similar facts.

The evolution of the law has thus – to a greater extent than in a code-based system – been fact-driven. In the language of the sciences, the case law system may be described as being more empirical and the code-based system as more deductive.

This fact-oriented approach to developing the law is, however, detrimental in that it makes it more difficult to reliably predict how a court will rule in situations in which the facts are similar but not identical. To date, there have been no reports of English cases directly concerned with the liability of rating agencies for (allegedly) defective ratings.[45] The cases analyzed below concern mainly auditors. Audit reports are similar to ratings to the extent that both express expert opinions on which others base their actions. Ratings and audit reports are paid by the soliciting company, but their content serves merely as guidance to a greater public, nothing more.

Audit reports and ratings differ, however, in some respects. Ratings are intentionally provided to future investors knowing that they will induce reliance. Audit reports, on the other hand, are not delivered with the primary inten-

[44] Dieter Blumenwitz*, Einführung in das anglo-amerikanische Recht*, 6th ed., (München: Beck Verlag, 1998), § 3, 26; on the practical consequences of this principle, cf. Lars Niemann and Reiner Quick, "Die Dritthaftung von gesetzlichen Abschlußprüfern in Großbritannien," *RIW* 1992, 836-843 (837).

[45] Iain MacNeil, An *Introduction to the Law on Financial Invesment*, (Oxford: Hart Publishing, 2005), 346: "The liability of rating agencies for negligence is a matter that appears to be untested in the UK courts."

tion of being shown to investors, but rather, aim to enable better control of management for the existing shareholders. This difference is crucial and the case law involving auditors should, therefore, not be considered conclusive for rating agencies. A court may always employ the rather restrictive auditor-related precedents to rating agencies because it finds the reasoning to be persuasive, but the court, with reference to the facts, may also choose, of course, to not follow the precedent, arguing that such a different fact pattern merits a different holding and outcome.

6.4. The end of the writ system

Under traditional common law, claimants had to prove an action through the filing of an exhaustive list of petitions called "writs." The idea is stated most clearly in the saying:

Ubi est actio, ibi est jus.
("The material right is where the procedural action is.")

Thus, traditionally, plaintiffs had to argue by analogy to existing cases.[46] This limitation was formally lifted in 1875.[47] Still, in torts the plaintiff, at least until *Donoghue v. Stevenson*, would have to follow precedents to prove the merits of his or her case rather than to argue on the basis of some generic concept.

6.5. Privity of contract and the need for consideration

Under common law, the contractual basis for procedural action requires consideration or a replacement thereof (like reliance). Consideration means that a contractual claim arises where the parties to an agreement have exchanged promises only in exchange and not gratuitously. An agreement to donate is thus unenforceable (at least in principle). The effect of such a consideration requirement is "privity of contract," which means that only the parties to such an exchange of promises may claim the respective performance of the exchanged

[46] Franco Ferrari, "Produkthaftung und Negligence, Sechzig Jahre *Donoghue v. Stevenson*," *ZEuP* 1993, 354-359 (357).
[47] Franco Ferrari, "Produkthaftung und Negligence, Sechzig Jahre *Donoghue v. Stevenson*," *ZEuP* 1993, 354-359 (354).

promises. Third parties are thus – *a priori* – excluded from claiming performance or damages for non-performance. Investors suing a rating agency would thus be precluded from actioning on the grounds of breach of contract.

6.6. Tort law

The various actions for torts have traditionally followed the rule of precedents and were thus conceptually limited to formerly recognized fact patterns. Like the US common law system of torts, the UK system recognizes a number of specific torts and the generic tort of negligence.

6.6.1. The specific torts – libel and slander

Generally, ratings are only opinions. For liability incurred as a result of fraudulent factual statements, please refer to Section "Liability for fraudulent statements of facts under Rule 10b-5 of 10b-5 of the Securities and Exchange Act," which may give some indication of the considerations that an English judge might take into account. Libel and slander, as sub-categories of the law of defamation, also apply in cases of statement of opinion.

Procedurally, in the UK the common law grounds of libel and slander are supplemented by the Defamation Act 1996. Libel comprises written or other statements conveyed through the media that have a derogatory character. Oral statements fall under slander. A mere rating action, i.e. the assignment of a prognosis for future default, however, does not generally contain a statement that would negatively affect the issuer's reputation in the eyes of society.[48]

A rating may lower financial reputation with regard to the probability of default, but it is not a statement intentionally directed to lower the social status of the issuer. In a capitalist society, the probability of default as such is not a value that carries with it social esteem because some likelihood of default is taken as granted by all market participants, and it is this social rather than financial esteem to which slander and libel relate. Slander and libel are thus, generally not applicable in cases of rating actions.

6.6.2. The generic tort – negligence

The generic tort of negligence in common law has three basic conditions[49]:

1. Did the defendant have a duty of care vis-à-vis the plaintiff?
2. Did the defendant breach this duty of care?
3. Did the plaintiff suffer a loss as a result of this breach?

These components have been subject to extensive litigation. It will be shown that under UK law, a duty of care may also exist with respect to third parties, such as investors relying on a rating action. That duty may stem from statutory law or from common law principles.

[49] C.J.H. Jansen and A.J. van der Lely, "Haftung für Auskünfte; ein Vergleich zwischen englischem, deutschem und niederländischem Recht," *ZEuP* 1999, 229 (236).

6.6.3. Breach of a statutory duty of care

In *Lloyd Cheyham & Co. v. Littlejohn & Co.,*[50] the auditors were able to defend themselves successfully by demonstrating that they were in compliance with Accounting Standards.[51] Similarly, the degree of care that the courts in the UK demand from rating agencies depend on statutory capital market law as far as it is applicable to them.

6.6.3.1. The Financial Services and Markets Act 2000

The Financial Services and Markets Act 2000 (FSMA) is the financial code that covers most areas of capital market law. Although the FSMA has already been subject to various modifications, it still remains a masterpiece of financial market law.

This act created a unique body of legal literature by merging several different, partly self-regulatory supervisory functions into the so-called Financial Services Authority[52]. It represents the United Kingdom's implementation of various EU directives (the prospectus directive,[53] the transparency directive, the *UCITS* directive, the investment services directive,[54] the banking directive, etc.), which required governmental administration rather than self-regulation.

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[50] In *Lloyd Cheyham & Co. v. Littlejohn & Co.*, [1987] BCLC 303, 305.
[51] Statements of Standard Accounting Practice.
[52] Part 1, The Regulator, section 1, FSMA, copyright status of material: Crown Copyright 2000.
[53] On the implementation of the first prospectus directive, Stefan Reinhart and Gottfried Thiery, The Public Offers of Securities Regulations in 1995, "Zur Umsetzung der 'Prospektrichtlinie' im Vereinigten Königreich im Vergleich zum deutschen Verkaufsprospektgesetz," *WM* 1996, 1565-1573.
[54] Iain MacNeil, *An Introduction to the Law on Financial Invesment,* (Oxford: Hart Publishing, 2005), 296.

In a common law system, however, the legislative drafting technique is probably more detailed as legal practitioners are more used to thinking according fact patterns and have developed the habit of reasoning by factual analogy rather than via deduction from abstract theories. Thus, the FSMA alone contains 433 sections and 22 schedules in its annexes; it is an extremely voluminous act of law.

6.6.3.2. Insider dealing and market abuse provisions

Directly applicable to rating agencies are those sections which implement the insider dealing and market abuse directive. Ratings in and of themselves do not constitute "advice" with regard to specific investments and are thus not subject to those areas regulated by the FSMA. The provisions on insider dealing complement the prohibition contained in Part V of the Criminal Justice Act 1993 (CJA).[55] During the rating process, rating agencies may have access to "insider information"[56]: This information is precise in nature, relates to a particular issuer and may be used as material upon which to base the pricing of securities.

[55] Section 52 of the CJA establishes three separate offences:
- dealing;
- encouraging another person to deal; and
- disclosing information.

[56] Section 56 CJA: Insider information is defined as information which:
"(a) relates to particular securities or to a particular issuer of securities or to particular issuers of securities and not to securities generally or to issuers of securities generally;
(b) is specific or precise;
(c) has not been made public; and
(d) if it were made public would be likely to have a significant effect on the price of any securities."

Such information comes "from an inside source,"[57] namely from the management of the issuer. Thus, rating agencies are unable to take advantage of this information for self-trading or abuse their privileged information access by passing this information on to third parties (in return for a favor).

Also, the rating action itself constitutes important information that may have an impact on the trading of both bonds and stocks and, thus, is itself subject to the prohibitions of insider and market abuse law.[58] The rating may therefore not be passed on selectively to anybody else but to the issuer without potentially making the rating agency guilty of an offense (both criminal and civil).

Market abuse may arise through three types of behavior leading to the misinformation of the (UK) financial markets:

(a) behavior based on information which is not generally available to those using the market but which, if available to a regular user of the market, would be or would likely be regarded by him as relevant when deciding the terms on which transactions in investments of the kind in question should be effected ("misuse of information");

(b) behavior likely to give a regular user of the market a false or misleading impression as to the supply of, or demand for, or as

[57] Section 57 CJA, a person has information from an inside source if and only if
"(a) he has it through –
i. being a director, employee or shareholder of an issuer of securities; or
ii. having access to the information by virtue of his employment, office or profession; or
(b) the direct or indirect source of his information is a person within paragraph (a)."
That requirement is no longer existent under the German equivalent provision of § 15 *WpHG*, cf. Part 7.4.2. Other provisions of financial law pertaining to rating agencies.

[58] Frank Partnoy, "The Siskel and Ebert of Financial Markets? Two Thumbs down for the Credit Rating Agencies," *Washington University Law Quarterly*, vol. 77, no. 3, 1999, 620-711 (646).

to the price or value of, investments of the kind in question ("misleading impression");

(c) behavior likely to distort the market in investments of the kind in question ("market distortion").

The behavior must be such that it is likely to be regarded by a regular user of the market in question who is aware the nature of this type of behavior as a failure on the part of the person or persons concerned to observe the standard of behavior reasonably expected of a person in his or their position in relation to the market. This standard of behavior is further defined by a FSA Code of Market Conduct.[59] Disciplinary proceedings of the FSA for market abuse are civil in character, but there is some dispute as to whether the safeguards of the European Convention on Human Rights applicable to criminal cases also extend to such proceedings.[60]

6.6.4. Breach of duty of care based on Common Law principles

As the statutory provisions establishing a duty of care for rating agencies are relatively scarce, the main focus for establishing a breach of duty is on obligations arising from Common Law principles. In *Donoghue v. Stevenson*, the House of Lords recognized that a duty of care towards third parties could exist; while Donoghue is only applicable to bodily harm injuries, the rationale was later extended to pure economic harm.

[59] The Code of Market Conduct contains two safe harbors, section 119 (2) and 118(8) FSMA.
[60] Iain MacNeil, An Introduction to the Law on Financial Invesment, (Oxford: Hart Publishing, 2005), 302.

6.6.4.1. Duty of care vis-à-vis third parties with physical injury: Donoghue v. Stevenson

Before the House of Lords' decision of *Donoghue v. Stevenson,*[61] the courts were very reticent to acknowledge the existence of a duty of care towards third parties to an agreement. The problem is not inherent to UK law, i.e. if such a duty is recognized, tort law could potentially serve as a way to avoid the privity of contract limitations.[62]

The facts of what may be the "most important decision in all common law"[63] are as follows: After finding the remains of a rotten snail in a bottle of ginger beer made by Stevenson from which she had already drunk, Mrs. Donoghue suffered a shock and fell ill with gastroenteritis also. By a close majority (three judges in favor, two against), the House of Lords allowed Mrs. Donoghue to recover her immaterial damages from Stevenson. On the grounds of *Donoghue v. Stevenson,* it is now recognized that a duty of care may exist towards third parties to an agreement. The so-called neighbor principle is based on the works of Frederick Pollock who opined in 1889[64]:

> "Thou shalt not hurt thy neighbour. Our law of torts, with all its irregularities, has for its main purpose nothing else than the development of this precept."

[61] *Donoghue v. Stevenson,* [1932] All England Law Reports (All ER) 1, House of Lords 26. May 1932.
[62] Cf. Lars Niemann and Reiner Quick, "Die Dritthaftung von gesetzlichen Abschlußprüfern in Großbritannien," *RIW* 1992, 836-843 (838).
[63] Joseph C. Smith, Peter Burns, "The Good Neighbour on Trial: Good Neighbours Make Bad Law," 17 *U.C.B.L. Rev.* 93 ff., 1983.
[64] Frederick Pollock, *The Law of Torts,* (London, 1889), 12.

Lord Atkin in *Donoghue v. Stevenson* formulated this neighbor principle somewhat differently but its essence remained the same[65]:

> "One must take reasonable care to avoid acts or omissions which … can injure … persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question."

A duty of care vis-à-vis third parties may thus exist to "persons whom one ought reasonably to have contemplated as being affected." This certainly would be the case for rating agencies because these must anticipate the effects of their ratings on investors' prior to rendering their decisions.

6.6.4.2. Duty of care vis-à-vis third parties without physical injury or damage to property

The extension of the duty of care in *Donoghue v. Stevenson* was initially limited to cases where parties had endured bodily harm or damage to their property. Later, however, the reasoning was extended to cases where no such primary injury had occurred and only economic losses were at stake (pure economic losses).

While the development of a duty of care for third parties enduring only pure economic loss was relatively straightforward in the legal history of the UK, the recognition of such a duty of care for third parties relying on defective statements is still heavily disputed. The operative word used in this context is "proximity" and the issue at hand in the cases discussed below was always

[65] Per Lord Atkin in *Donoghue v. Stevenson,* (1932) A.C. 562, 580.

whether the plaintiff could invoke sufficient proximity to the defendant thus meriting the holding of a duty of care.

6.6.4.2.1. Recovery for actions: Ross v. Caunters and White v. Jones

In *Ross v. Caunters,*[66] the lawyers being sued had wrongfully instructed the husband of the testator to witness the signing of the will even though according to s. 15 Wills Act 1837, such witnessing by a husband of the beneficiary renders the will void. The Chancery Division decided that the lawyers were responsible to the failed beneficiary of the void will.

In *White v. Jones,*[67] the testator had wanted to change his will for the benefit of his daughters who had been hitherto excluded. He instructed a lawyer (Mr. Jones) to change his will. The lawyer delayed however, and the testator died before any changes were made to his will. One of the daughters (Mrs. White) claimed compensation from the lawyer for the foregone inheritance. The House of Lords recognized a duty of care in favor of the heirs despite the lack of contract. In the context of a comparative law analysis, that which Deakin, Johnston and Basil thereof conclude is also worth noting:

> "White v. Jones is, thus, conceptually akin (but not identical) to the notion of contract in favour of third parties, used in some United States jurisdictions (and Germany) to solve this kind of problem."[68]

Lord Justice Farquharson argued in favor of the plaintiff (by quoting two other decisions) with reference to the role of attorneys in the community

[66] [1979] 3 AllER 580, Ch.
[67] *White and Another Respondents v. Hones and Another Appellants*, House of Lords, [1995] 1 AllER 691.
[68] Simon Deakin, Angust Johnston and Basil Markesinis, *Tort Law,* 5th ed., (Oxford: Oxford University Press, 2003), 125.

and to the potential lack of effective sanctions if no duty was extended to the heirs:

> "… To deny an effective remedy in a plain case would seem to imply a refusal to acknowledge the solicitor's professional role in the community. In practice the public relies on solicitors … to prepare effective wills. It would be a failure of the legal system not to insist on some practical responsibility. …
> If this [no liability to heirs] is right, the result is striking. The only person who has a valid claim has suffered no loss, and the only person who has suffered a loss has no valid claim. However grave the negligence, and however great the loss, the solicitors would be under no liability to pay substantial damages to anyone."[69]

Similarly, an attorney has a duty of care to properly install a mortgage on behalf of the purchaser of real estate even if his mandate to install such a mortgage stems from the guarantor of the mortgage and not from the purchaser.[70] While this series of cases only concerns third-party recovery for actions, these cases are still noteworthy because they allow for third party recovery without reliance.[71] Third party recovery for defective statements on the grounds of negligence is, however, still heavily disputed.

6.6.4.2.2. Recovery for statements

The amount of case law on recovery for (allegedly) defective statements is vast and it will be shown that findings by the judiciary are conflicting or in-

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[69] *White and Another Respondents v. Hones and Other Appellants,* [1995] 2 A.C. 207, 232.
[70] *Woodward v. Wolferstans* (a Firm), High Court (Chancery Division), decision of 20.3.1997, PLC 1997 VIII (5), 60; cf. Klaus Vorpeil, "Neuere Entwicklungen im englischen Handels- und Wirtschaftsrecht," *RIW* 1997, 1046-1052 (1047).
[71] Cf. Christian Kessel, who outlines this peculiarity with respect to White v. Jones only, but the reasoning should apply to all three cases cited here. Christian Kessel, "Neues zur Anwaltshaftung gegenüber Dritten in England, " *NJW* 1996, 30-32 (31).

applicable to rating agencies. As such, the issue remains unresolved under UK law.

6.6.4.2.3. Candler v. Crane's minority holding

In 1951, the Court of Appeals still denied recovery in a situation such as *Candler v. Crane, Christmas & Co*.[72] Crane was an auditor who rendered a defective report knowing it would be presented to Candler. Candler sued Crane for lost investment. The majority of the court denied recovery for lack of duty of care. In the long run, however, the minority vote by Lord Justice Denning had greater influence than the majority holding. Lord Denning argued that a legal system that required auditors' due diligence only vis-à-vis its immediate clients provided insufficient protection. In his view, the auditor owed a duty of care to all persons to whom the auditor knew the report would be presented.

[72] *Candler v. Crane, Chistmas & Co.,* [1951] 2 K.B. 164 (C.A.).

6.6.4.2.4. Hedley Byrne v. Heller: "Special relationship" for a bank's defective advice

Twelve years later the House of Lords again relied on Lord Denning's minority vote to render a verdict on *Hedley Byrne v. Heller*. The plaintiffs were anxious to know whether they could safely give credit to the company Easipower, and they therefore sought bankers' references on the company. The plaintiffs' banker approached the bankers of Easipower, who later became the defendants, and the defendants, not knowing the identity of the plaintiffs gave favorable references on two occasions.[73] These were marked "Confidential. For your private use…" before being passed on to the plaintiffs by their banker. In *Hedley Byrne v. Heller,*[74] the House of Lords held that giving advice construed a "special relationship" requiring the duty of care of the advisor. The House of Lords stated three conditions with respect to the responsibility for negligent statements:[75]

1. The addressee, for whom the advice was intended, would rely on the knowledge and abilities of the advisor.
2. The advisor knew or should have known that the person to whom the advice was addressed would rely on the accuracy of the advice.
3. In the circumstances of the case, the advisee could justifiably act in reliance on the advice.

[73] Cf. W.V.H. Rogers, *Winfield and Jolowicz on Tort*, 15th ed., (London: Sweet & Maxwell, 1998), 366.
[74] *Hedley Byrne v. Heller* [1963] 2 AllER 575, HL.
[75] C.J.H. Jansen and A.J. van der Lely, "Haftung für Auskünfte; ein Vergleich zwischen englischem, deutschem und niederländischem Recht," *ZEuP* 1999, 229 (237).

In the end, however, no recovery occurred because the bank had successfully excluded potential liability by issuing the disclaimer.

The effect of *Hedley v. Heller* was two-fold: First, it was now recognized that the advisor owed a duty of care vis-à-vis third parties and risked being sued for defective statements on the grounds of negligence. Second, such liability could be excluded by exemption clauses. As a result, whole industries (lawyers, accountants, banks, etc.) "implemented" *Hedley* by invoking "disclaimer-of-responsibilities" clauses.[76]

Applicability of *Hedley v. Heller* to rating agencies:

If the decisions on liability from *Hedley v. Heller* are deemed applicable to auditors,[77] then the same should also hold true with respect to rating agencies. Banks, auditors, and rating agencies all have something in common, in that each of them assumes a position of particular expertise vis-à-vis the advisee. Of course, it could be argued that ratings do not constitute advice because the recipient of a rating does not receive a recommendation for a particular investment. In *Hedley v. Heller*, however, the bank did not issue "advice" in the form of a recommendation as such. In fact, the term "advice" does not necessarily imply that the advisor recommends or describes a particular investment with the intention of making it more attractive to the advisee. Advice is also given when the issuer of a statement assumes a position of trust and presents himself as an "expert" in his field knowing that third parties will, for that very reason, rely on his expertise. As in other contexts of tortuous conduct, intent does not require that the harmful result be the goal of the behavior as long as inducement by the

[76] For the accounting industry, cf. Lars Niemann and Reiner Quick, "Die Dritthaftung von gesetzlichen Abschlußprüfern in Großbritannien," *RIW* 1992, 836-843 (841).

[77] Lars Niemann and Reiner Quick, "Die Dritthaftung von gesetzlichen Abschlußprüfern in Großbritannien," *RIW* 1992, 836-843 (838).

statement is foreseeable. In fact, the more the advisor behaves as if the resulting inducement was irrelevant to him, the more persuasive the advice will seem to the advisee. Therefore, the knowledge that third parties may rely on its expertise, it makes no difference whether it is a bank (as in *Hedley v. Heller*), an auditor, or a rating agency that issues its expert statement.

6.6.4.2.5. Anns v. Merton London Borough (Anns Test)

In *Anns v. Merton London Borough,*[78] Lord Wilberforce tried to install a generic test of requirements for determining whether such a duty of care exists (so-called "Anns" or neighborhood test):

> "… The position has now been reached that in order to establish that a duty of care arises in a particular situation, it is not necessary to bring the facts of that situation within those of previous situations in which a duty of care has been held to exist. Rather the question has to be approached in two stages.
> First one has to ask whether, as between the alleged wrongdoer and the person who has suffered damage there is a sufficient relationship of proximity or neighbourhood such that, in the reasonable contemplation of the former, carelessness on his part may be likely to cause damage to the latter – in which case a prima facie duty of care arises.
> Secondly, if the first question is answered affirmatively, it is necessary to consider whether there are any considerations which ought to negate, or to reduce or limit the scope of the duty or the class of person to whom it is owed or the damages to which a breach of it may give rise."[79]

The courts thereafter applied a three-prong test: A duty of care was admitted if the damage to the third person was foreseeable, a relationship of prox-

[78] *Anns v. Merton London Borough,* [1977] 2 AllER 492, HL (per Lord Wilberforce at 489 f.).
[79] *Anns v. Merton London Borough,* [1977] 2 AllER 492, HL (per Lord Wilberforce at 489 f.). [1978] A.C. 728, 751.

imity existed among the parties, and if, with consideration of the facts of the case it would be fair, just, and reasonable to require a duty of care from the defendant.[80] In practice, the test led to an extension of liability that was in all probability unintended.[81] The auditing industry in particular urged the legislator to take action due to the fact that auditors were (and still are) not allowed to limit their liability through contract.[82] A commission report (the Likierman report of 1988), suggesting auditors be allowed to limit their liability did not, however, have any effect on parliament.[83]

6.6.4.2.6. Caparo v. Dickman (auditors reports only for shareholder assembly)

In *Caparo Industries Plc. Respondents v. Dickmann and Others Appellants,*[84] the House of Lords rejected the three-prong test, proposed a four-prong test, and declared its own test "non-conclusive." This case implies a partial return to the earlier writ-system. The facts were as follows: Caparo had purchased shares of Fidelity in reliance on the (defective) audit report of Dickman that showed a profit of GBP 1.3 million. Instead of a profit, however, a loss was later disclosed to the sum of GBP 465,000 and the share price tumbled. Caparo endured an economic loss and sued Dickman, arguing that a special relationship existed between Dickman and Caparo due to his reliance on the audit report.

[80] Lars Niemann and Reiner Quick, "Die Dritthaftung von gesetzlichen Abschlußprüfern in Großbritannien," *RIW* 1992, 836-843 (839).
[81] Lars Niemann and Reiner Quick, "Die Dritthaftung von gesetzlichen Abschlußprüfern in Großbritannien," *RIW* 1992, 836-843 (839).
[82] This is a result of Section 310 of the Companies Act 1985. Unlike under German law, there is no statutory limit to the liability of auditors for their reports.
[83] Lars Niemann and Reiner Quick, "Die Dritthaftung von gesetzlichen Abschlußprüfern in Großbritannien," *RIW* 1992, 836-843 (838).
[84] *Caparo Industries Plc. Respondents v. Dickmann and Other Appellants*, [1990] 2 WLR 358, HL (per Lord Bridge at 356, per Lord Roskill at 374, per Lord Oliver at 379 f.).

Lord Oliver of Aylmerton, however, did not agree with the plaintiff's line of reasoning: [85]

> "What can be deduced from the Hedley Byrne Case, therefore, is that the necessary relationship between the maker of a statement or giver of advice (the adviser) and the recipient who acts in reliance on it (the advisee) may typically be held to exist where (1) the advice is required for a purpose, whether particularly specified or generally described, which is made known either actually or inferentially, to the adviser at the time when the advice is given, (2) the adviser knows, either actually or inferentially, that his advice will be communicated to the advisee, either specifically or as a member of an ascertainable class, in order that it should be sued by the advisee for that purpose, (3) it is known either actually or inferentially, that the advice so communicated is likely to be acted on by the advisee for that purpose without independent inquiry and (4) it is so acted on by the advisee to his detriment. That is not, of course, to suggest that these conditions are either conclusive or exclusive, but merely that the actual decision in the case does not warrant any broader propositions."

Lord Bridge of Harwich consented and denied that it would make any difference if the investor relying on such (potentially) defective argument were a shareholder prior to his (further) investment.[86]

The court rejected Caparo's claim arguing that the audit report was intended to serve the general shareholder assembly to allow them to control the board of directors. The audit report was thus not be intended to serve as a basis for the purchase of shares, be it through existing or new shareholders.

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[85] *Caparo Industries Plc. Respondents v. Dickmann and Other Appellants*, [1990] 2 WLR 358, HL (per Lord Bridge at 356, per Lord Roskill at 374, per Lord Oliver at 379 f.).

[86] *Caparo Industries Plc. Respondents v. Dickmann and Other Appellants*, [1990] 2 WLR 358, HL (per Lord Bridge at 356, per Lord Roskill at 374, per Lord Oliver at 379 f.) = [1990] 2 A.C. 605, 627: "Assuming for the purpose of the argument that the relationship between the auditor of a company and the individual shareholders is of sufficient proximity to give rise to a duty of care, I do not understand how the scope of that duty can possibly extend beyond the protection of any individual shareholder from losses in the value of the shares which he holds. As a purchaser of additional shares in reliance on the auditor's report, he stands in no different position from any other investing member of the public to whom the auditor owes no duty."

The holding in the Caparo case meant a return to the traditional common law system. Lord Justice Bridge argued that if a case warranted a duty of care, one would have to analyze whether the case was classifiable among the existing fact patterns. Development through analogy with existing cases rather than through imprecise generic criteria was the demand made by Lord Justice Bridge.[87] *Murphy v. Brentwood DC*[88] also follows this approach of "incremental development of the law."

Similarly, in *Al Saudi Banque v. Pixley,*[89] the House of Lords decided that no duty of care existed vis-à-vis the creditor. Lord Justice Millet argued:

> "Claims for damages for economic loss resulting from negligent misstatement, however, are very different. There is potential for foreseeable but indeterminate and possibly ruinous loss by a large and indeterminate class of plaintiffs. Foreseeability of reliance by itself is not an adequate limiting factor…
> Two control mechanisms for limiting the ambit of the duty of care can be discerned in the authorities: (i) to limit the transaction in which the defendant's statement may be relied upon to the transaction in which he intended it, or knew that it was intended, to be relied upon; and (ii) to limit the plaintiff or class of plaintiff to the person or persons to whom the defendant made the statement, or to whom he intended or knew that it was intended to be communicated."

The reliance of specific persons is not the intent of rating agencies, nor do they know specifically who will make use of this statement. Consequently, according to *Caparo v. Dickman* there would be no potential liability for rating agencies.

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[87] Cf. Lord Justice of Harwich, *The Weekly Law Reports 1990*, vol. 2, (London 1990), 365.
[88] Murphy v. Brentwood DC, [1990] 2 AllER 908, HL (per Lord Keith at 915); thereby adopting an Australian premise, cf. *Sutherland Shire Council v. Heyman* (1985) 59 ALJR 564, HC of A (per Brennan J at 588).
[89] *Al Saudi Banque v. Pixley*, [1990] 2 WLR 344.

Caparo v. Dickman should, however, not be applicable with respect to rating actions. Rating actions do not generally have an internal purpose, but rather, are geared towards the reliance of the capital markets. The rating agency also knows about the future use of the rating action assigned.

Even auditors themselves have expressed objections with respect to *Caparo v. Dickman*, claiming that the holding had no basis in economic reality.[90] In blue chip companies, minority shareholders have little means to exert influence on the board. Thus, the investment decision itself (buy, hold or sell) becomes the ultimate and only practical tool by which to have a say in the actions of the board. Even if one were to believe that auditors' reports only serve the purpose of controlling the board, if the value of auditors' reports were to be excluded for such investment decisions, this control would be artificially limited. Furthermore, from a general legal and economic perspective, the risks of un-diligent reports should be imputed to those who have the easiest economic means to reduce such risk, this being, in the case of auditors, the auditors themselves and likewise, in the case of rating agencies, the rating agencies themselves.

Caparo v. Dickman and *Al Saudi Banque v. Pixley* are both cases that are subject to dispute within the judiciary. In a more recent case, *Morgan Crucible Co. v. Hill Samual Bank Ltd. and others,*[91] an auditor confirmed a profit prognosis to the shareholders that turned out to be misleading due to the wrongful application of accounting principles. The plaintiff had purchased shares in the company relying on the defective prognosis. The Chancery Division rejected the plaintiff's motion on the grounds of *Caparo v. Dickman*, the second

[90] Lars Niemann and Reiner Quick, "Die Dritthaftung von gesetzlichen Abschlußprüfern in Großbritannien," *RIW* 1992, 836-843 (842).
[91] *Morgan Crucible Co. v. Hill Samual Bank Ltd. and others*, [1990] All ER 330, [1991] All ER 148 (CA).

instance, however, allowed recovery for the plaintiff. The case was then settled out of court.

Last but not least, it would constitute a certain incoherency if the law of torts were to deny a duty of care of auditors, rating agencies and other financial experts vis-à-vis third parties even though the statutory capital market law contains very explicit provisions for the qualitative behavior of these institutions.

6.6.4.2.7. James McNaughton v. Anderson

McNaughton was negotiating with MK, a company experiencing financial difficulties, for a friendly take-over. The CEO of MK asked his auditor, Anderson, to draft an audit report. According to the (defective) draft, MK was neither making profits nor suffering losses. The draft was presented to McNaughton, who, relying the information contained within it, decided to proceed with the take over of MK. In reality, however, MK had suffered substantial losses, and McNaughton sued Hicks Anderson. The court denied recovery arguing that the audit report was not addressed to him but to MK and that McNaughton could not justifiably rely on the report since it was only a draft.

Lord Justice Neill drew up six "headings" which a court should consider in its analysis:[92]

1. The purpose for which the statement was made.
2. The purpose for which the statement was communicated.
3. The relationship between the adviser, the advisee and any relevant third party.
4. The size of any class to which the advisee belongs.

[92] *James McNaughton Paper Group Ltd. v. Hicks Anderson & Co.* [1991] 2 Q.B. 113, HL; cf. C.J.H. Jansen and A.J. van der Lely, "Haftung für Auskünfte; ein Vergleich zwischen englischem, deutschem und niederländischem Recht," *ZEuP* 1999, 229 (238).

5. The state of knowledge of the adviser.
6. Reliance by the advisee.

However, neither argument claiming that reliance was not justified because McNaughton was not the formal addressee and because the report was but a draft, is very convincing. The formal addressee of the audit report, MK in this case, was not intended to be the final or primary addressee. The auditor knew the report would find further use with McNaughton. The status of the report as a draft was an element that the court should have integrated into its analysis as contributory negligence by McNaughton. According to section 1 (1) of the Law Reform Act 1945, contributory negligence reduces payable compensation.[93] McNaughton should have sought further evidence of the financial viability of MK before relying on a draft report. This is particularly accurate since McNaughton was a proficient investor. Thus, the nature of the report (draft vs. final) is an element that speaks against justified reliance, but it should not be seen as a blank check for the auditor exempting him from fault vis-à-vis third persons. Consequently, a partial recovery of McNaughton would have been more convincing than the formal argumentation of the court.

6.7. Conclusion in favor of a duty of care

Conflicting case law exists on the issue of whether third parties benefit from a duty of care for defective statements. While it is recognized that such duty can also exist vis-à-vis third parties (*Donoghue v. Stephenson*), there are

[93] This provision should be applicable to persons suffering harm as a result of auditors' defective reports, Lars Niemann and Reiner Quick, "Die Dritthaftung von gesetzlichen Abschlußprüfern in Großbritannien," *RIW* 1992, 836-843 (841); similarly, the provision should also be applicable vis-à-vis defective ratings.

cases both in favor of such duty for defective statements (minority opinion *Candler v. Crane, Hedley v. Heller* and *Anns v. Merton*) and against (majority opinion *Candler v. Crane, Caparo v. Dickman* and *James McNaughton Papers v. Hicks Anderson*). There seems to be particular reticence on the part of the judiciary to acknowledge such duty of care for the benefit of investors relying on defective expert statements. In fact, the underlying quintessence is probably that the judiciary is trying to prevent a *laissez-faire* attitude by investors who, rather than conducting proper research on their own account and responsibility, "rely" on the statement of professional advisers and sue such advisers if the investment turns out to be unprofitable.

This reticence could, however, also be countered by a generous application of the principle of contributory negligence. In fact, a professional investor has better research opportunities and thus – in equity – should not be allowed to rely as heavily on a single expert opinion as a "consumer investor." Of course, especially in the world of finance, the distinction between "professional" and "consumer" investors is difficult to make, as both may have access to the same type of information. Both may even process their order through the same means (internet banking, etc.). These distinguishing features of the advisee should, however, be assessed on an individual level (contributory negligence) rather than by a black and white analysis (no duty or duty with full recovery).

Besides being inconsistent, case law is not very conclusive either. The cases so far have concerned mainly auditors and lawyers; to my knowledge, there has, as of yet, been no case referring explicitly to rating agencies. In addition, transferring case law for auditors to rating agencies might not be worthwhile. Auditors are a company's internal gatekeepers. Their statements primarily serve to ensure the effective control of the board. The argument of *Caparo v.*

Dickman that auditor reports are not intended for investment decisions is not without merit.

Rating agencies, on the other hand, are external gatekeepers. Their grading is used primarily by external investors rather than for the internal control of corporate governance or correct accounting. Like auditors, rating agencies are experts in their field, but this fundamental difference between them and auditors makes rating agencies appear closer to the line of cases such as *Hedley Byrne v. Heller* and *Anns v. Merton London Borough* than to *Caparo v. Dickman* or *James McNaughton Papers v. Hicks Anderson*.

> Furthermore, if subjected to liability, auditors cannot limit their liability under current statutory law. Consequently, the judiciary is very reluctant to allow recovery or impute a duty of care vis-à-vis third parties.

In the context of rating agencies, *Hedley Byrne v. Heller*, i.e. the existence of a "special relationship" between the advisor and the advisee to correctly make use of the advice given, still seems to be the applicable rule of law, and the character of the investor, as well as his experience, should only be factors for the assessment of contributory negligence.

If *Hedley Byrne v. Heller* is the applicable rule of law, then naturally the question that follows is whether rating agencies can preclude their liability through disclaimer-of-responsibility clauses.

6.8. Disclaimer of responsibility-clauses

Disclaimer-of-responsibility clauses are subject to the test of "reasonableness" under the Unfair Contract Terms Act 1977. The purpose of this act is to enable the control of limitations or exemptions of liabilities for commercial trades that belong to the ordinary course of business. According to Section 2

(2), a limitation or exemption for negligently caused pecuniary damages must be "adequate" to be valid. The relative bargaining power of the parties involved is relevant to this analysis.

In *Smith v. Eric S. Bush,*[94] an appraiser had defectively assessed the value of a house. The Court of Appeals (Civil Division) held that in accordance with the Unfair Contract Terms Act 1977, it was up to the defendants to show that the requirement of reasonableness was satisfied in respect to the exclusion of liability [note of author: burden of proof on party claiming exclusion].[95] In deciding on this issue, all circumstances were to be taken into account and since the surveyor knew that a purchaser was likely to rely on the report, it was not reasonable to allow the defendants to rely on the disclaimer. The House of Lords confirmed this decision. The exemption clause was, in this case, invalid according to sections 2(2) and 11 (3) of the Unfair Contract terms Act 1977.

In *Smith v. Bush*, the House of Lords had to consider a consumer-business relationship (purchaser suing the surveyor of real estate) and Lord Griffith observed, "the disclaimer is imposed on the purchaser who has no effective power to object." The House of Lords also noticed that the surveyor was likely to be insured against liability and that the liability in question was unlikely to be extensive as the duty was limited to those buying "modest houses" such as "young first time buyers [who] are likely to be under considerable financial pressure." From this line of arguments Deakin/Johnston and Basil conclude:[96]

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[94] *Smith v. Eric S. Bush,* [1989] 2 W.L.R. 790; [1989] 2 All E.R. 514, H.L. [E.]. Cf. *The Weekly Law Reports 1990*, vol. 2, (London 1990), footnote 58, pages 367-368.
[95] The decision of the Court of Appeals is reported among others by, *Smith v. Eric S. Bush* [1987] 3 All E.R. 179.
[96] Simon Deakin, Angust Johnston and Basil Markesinis, *Tort Law*, 5th ed., (Oxford: Oxford University Press, 2003), 122.

> "Claimants with the capacity for renegotiation or for contracting for the desired service elsewhere are unlikely to benefit from this approach to disclaimers."

Consequently, one might argue in favor of disallowing a disclaimer when individual consumers are involved, but allowing for such a disclaimer when business investors are at stake.

In the case of ratings, differentiating in this way would not necessarily be convincing. The line between the consumer investor and the professional investor is a thin one. Investment banks treat individuals with "private wealth" much like other professional investors.

Also, in practice, professional investors are more likely to rely on ratings in a timely manner, thus allowing only for the more fictitious "reliance" of private individual investors that would not entirely correspond to the role rating agencies play for the professional business community in particular. Conversely, the smaller individual investor is unlikely to rely on specific ratings. Typically, some time will have elapsed before the smaller investor receives the information provided in a rating whereas professional investors will receive information that is up-to-date. In the language of the efficient market hypothesis, the consumer investor will be considered a price taker. On the other hand, a private investor will almost certainly have few other sources of information to rely on and will have to place greater trust on the judgment of other professional business experts like analysts, rating agencies, etc.

Moreover, from the point of view of the rating agency, differentiating with respect to the type of investor who actually relies on the information would not make much sense. A rating agency will typically disclose its rating to the general public and therefore cannot predict to whom their ratings will ulti-

mately be disclosed. It would make little sense to have differing duties and disclaimer possibilities relative to such a varied investor base.

Rating agencies intend to have their ratings published for the entire financial market because the informational value of each rating increases with increased coverage and comparability of information.

From these economic realities, whether the investor subscribed to a regular database provided by the rating agencies or not cannot be determined. Such differentiation would not be convincing. Were this the case, economically speaking, rating agencies would be treated as if they were providing screening services whereas the bulk of their revenue is "from issuer fees, i.e. Signalling services).

Rating agencies are similar to other business professionals that also offer what can be classified as "signalling services" (international law firms, auditing companies, etc.). Their communications, no matter how they are channeled and objectified, remain prospectus information in the eyes of the investor. Thus, rating agencies should be treated as if the issuer himself were expressing an opinion on the issue and, consequently, should be held to the same standard of care that would be applicable were the issuer himself making these assertions.

If an issuer were to accompany his prospectus information with a disclaimer that the judgments contained therein could not give rise to liability if misleading, such information would probably not be adhered to. Similarly, for rating agencies, since the issuances are often geared towards obtaining a certain rating, the rating agencies should not be absolved of liability merely by means of a single sentence that reveals the possible inaccuracy of the material presented. If an expert makes an opinion knowing of the reliance he will thereby

induce, he should not be allowed to act contradictorily by allowing such inducement and waiving all responsibility for the statement.

In today's financial markets, all investors must rely on the professional judgment of rating agencies to a certain extent because the information contained in ratings is often confidential. If the market participants were to ignore the rating, they would thus miss out on an important piece of information and thus consistently mis-price their investments. Therefore, investors cannot replicate (or increase the accuracy of) that information through their own efforts; if they did not, however, rely at least to a certain extent on ratings, they would consistently misprice and soon be out of business. The law must not close its eyes to these economic realities and argue in favor of the autonomous investor. Rather, the objective of the law should be to define the responsibilities of experts, such as rating agencies, in the financial markets. Accordingly, disclaimers should not have any validity at all.

6.9. Conclusion for UK law

Case law is conflicting both with regard to the question of duty of care and to disclaimers. The view held here is that there also exists a duty vis-à-vis potential investors and that disclaimers have no bearing on a potential action. The decisive issue to resolve will, therefore, not relate to the preliminary questions of jurisdiction, applicable law, duty of care or disclaimer, but will rather be a matter of establishing when such a breach of a duty of care took place. For that purpose this book proposes criteria common to all jurisdictions. When statutory UK capital market law establishes diligence standards, it is these criteria that remain determinative.

7. German Law

Unlike in the US, to date there have been no rulings in Germany challenging rating agencies for their actions.[97] On the contrary - and this time much as in the United States - the judiciary gives its formal approval of the rating business by requiring banks to disclose to clients when the suggested security lacks an external rating.[98] There is, however, no formal administrative regulation of the rating business. According to sections 31 seq. of the law on financial services rating agencies are not financial service providers (Wertpapierhandelsgesetz), nor are they subject to the markets-in-financial-instruments directive of April 21, 2004.[99]

7.1. Applicability of German law

German law may apply as a result of a choice of law clause. Since rating agencies mostly stem from Anglo-Saxon jurisdictions and since these jurisdictions as has been seen above so far provide for the absence of judicial review with respect to rating agencies, understandably, rating agencies intend to avoid the applicability of German law. The issue is thus rather, if they may avoid the applicability of German law than if they may elect to submit a rating agreement to German law (which would not raise many issues).

[97] This might change in the near future, given the recent scandal involving a rating report by the rating agency Scope and the disastrous effects for the real estate mutual fund market in Germany. The fund company KanAm was particularly affected as well. Cf. Hanno Beck, "Rational irrationale Flucht aus Immobilienfonds," FAZ, January 24, 2006, Nr. 20, S. 21; the real estate mutual fund industry and the German legislator are now actively discussing reforms to the legal regime for mutual funds.
[98] Oberlandesgericht Nürnberg (Regional High Court) *ZIP* 1998, 380.
[99] Matthias Habersack, "Rechtsfragen des Emittenten-Ratings," *ZHR* 169 (2005), 185-211 [191]; OJ Nr. L 145/1 of 30.4.2004.

7.1.1. In the absence of a choice of law clause

In the absence of a choice of law clause, the German international private law (Einführungsgesetz zum Bürgerlichen Gesetzbuch, *EGBGB* - the Introductory Law to the Civil Code) states that the law which is applicable is that law which shows the greatest nexus to the contract at stake, presumed to be the country on whose territory the specific non-monetary performance is to take place. If the obligor of the specific performance has a head office, the country in which the head office is located is presumed to show the greatest nexus or, if the performance is to be made through a permanent establishment, the country of that permanent establishment takes on this role.[100]

In the case of a rating agreement, the non-monetary performance serves as the rating, and the place of residence of the rating agency is thus decisive in determining the applicable law. For a permanent establishment to qualify under this provision, it is sufficient that the contracting party directly address its business to such a permanent establishment. Since all major rating agencies have such permanent establishments that provide enable first contact, German law would, in the absence of a contractual stipulation to the contrary, generally be applicable.[101]

[100] *EGBGB* art. 28 para. 2 sent. 2.
[101] In this sense also, Lutz Krämer, "Aktuelle Rechtsfragen des externen Ratings," in "Internes und externes Rating, Aktuelle Entwicklungen im Recht der Kreditsicherheiten – national und international," *Schriftenreihe der Bankrechtlichen Vereinigung*, vol. 24, eds. Walther Hadding Klaus J. Hopt and Herbert Schimansky, (Berlin: Justus Liebig Universität, 2004), 11.

7.1.2. In case of a choice of law clause

Of course, if German law is elected as the stipulating law in a situation involving a German issuer, a German court will recognize such choice of law.[102] Lutz Krämer[103] reports that the "tendency" to submit the rating agreement to German law "would be noticed." In the past at least, agreements sometimes contained a choice of law clause in favor of New York law.[104] Moody's Terms of Agreement, for example, provided that:

> "This Agreement shall be governed by, and construed in accordance with, the laws of State of New York applicable to contracts made and to be performed wholly within such State." [105]

Art. 27 *EGBGB* deals with choice-of-law clauses in contractual agreements. According to Art. 27 paragraph 1, parties are free to choose the law to be applied to their agreement. The choice should be made either by an explicit provision or be derived with relative certainty from the provisions of the contract (Art. 27 para. I sent. 2 *EGBGB*).

It is, however, not possible to opt out of mandatory rules of a particular jurisdiction if the facts only pertain to such jurisdiction (Art. 27 paragraph 3,

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[102] Art. 27 para. 1 sent. 1 *EGBGB*.

[103] Lutz Krämer, "Aktuelle Rechtsfragen des externen Ratings," in "Internes und externes Rating, Aktuelle Entwicklungen im Recht der Kreditsicherheiten – national und international," *Schriftenreihe der Bankrechtlichen Vereinigung*, vol. 24, ed. Walther Hadding Klaus J. Hopt and Herbert Schimansky, (Berlin: Justus Liebig Universität, 2004), 11.

[104] For example, the general agreement between Fitch IBCA Ltd. and its customers is made subject to English law, Andreas C. Peters, "Die Haftung und Regulierung von Rating-Agenturen," *Studien zum Handels-, Arbeits- und Wirtschaftsrecht,* vol. 69, (Hamburg: Nomos Verlag, 2000), 190.

[105] For example, the general agreement between Fitch IBCA Ltd. and its customers is made subject to English law, Andreas C. Peters, "Die Haftung und Regulierung von Rating-Agenturen," *Studien zum Handels-, Arbeits- und Wirtschaftsrecht,* vol. 69, (Hamburg: Nomos Verlag, 2000), 201.

"ordre public" exemption). According to Art. 27 paragraph 4, Art. 31 paragraph 1, the validity of the choice of law clause is determined by the law of the jurisdiction that would govern the contract, were the choice-of-law-clause valid. Therefore, German law indirectly subjects a choice-of-law-clause to foreign law and asks that foreign law accept the referral. In Moody's case, New York law would thus control the validity of the choice-of-law-clause.

In most instances, state law in the US does not provide explicit sections on questions relating to conflict of law, but rather, offers only specific rules on jurisdiction (and thereby indirectly provides choice-of-law provisions). Due to its large exposure to the international business community, New York law, however, does have some explicit rules on the question of choice of law. Title 14 of the New York State Consolidated Laws on General Obligations (GO), section 1401 number 1 states:

> "The parties to any contract, agreement or undertaking, contingent or otherwise, in consideration of, or relating to any obligation arising out of a transaction covering in the aggregate not less than two hundred fifty thousand dollars, including a transaction otherwise covered by subsection one of section 1-105 of the uniform commercial code, may agree that the law of this state shall govern their rights and duties in whole or in part, whether or not such a contract, agreement or undertaking bears a reasonable relation to this state. (…)"

New York law recognizes a choice of New York law if the contract involves obligations of $150,000 irrespective of whether the factual background pertains to New York. In order to choose NY courts as the forum in which to litigate, NY law requires a higher threshold of $1 million to be passed. section 5-1402 of the Consolidated Law on General Obligations provides for the option to choose a NY forum:

> "1. Notwithstanding any act which limits or affects the right of a person to maintain an action or proceeding, including, but not limited to, paragraph (b) of section thirteen hundred fourteen of the business corporation law and subdivision two of section two hundred-b of the banking law, any person may maintain an action or proceeding against a foreign corporation, non-resident, or foreign state where the action or proceeding arises out of or relates to any contract, agreement or undertaking for which a choice of New York law has been made in whole or in part pursuant to section 5-1401 and which (a) is a contract, agreement or undertaking, contingent or otherwise, in consideration of, or relating to any obligation arising out of a transaction covering in the aggregate, not less than one million dollars, and (b) which contains a provision or provisions whereby such foreign corporation or non-resident agrees to submit to the jurisdiction of the courts of this state."

It is not entirely clear whether the formulation "undertaking in consideration of, or relating to any obligation arising out of a transaction covering in the aggregate not less than…" relates only to the consideration at stake. Fees for the rating agreement itself seldom exceed $250,000. It could, however, be argued that the vague formulation includes rating actions which relate to issuances in excess of the threshold amount. It is hardly conceivable that there would be a rating action on an issuance with a value below to $1 million. If such an interpretation were adopted, then all choices in favor of NY law and of NY forum clauses would have to be considered valid under NY law.

In this case, German law would have to recognize such a finding and conclude its inapplicability to the contract. A German court would have to follow New York law, and would, as seen before, most likely dismiss any litigation against the rating agency.

The use of the word "consideration" does nonetheless indicate a more limited interpretation of section 5-1401 and 1402 of the Consolidated Law on General Obligations. Imagine the case of a European issuance of a €200 bond and a rating contract between a European issuer and the European subsidiary of

a US rating agency with fees of $100,000. Would it not considerably overextend the meaning of "relating to" to assume some relation to the State of NY only because the issuance at stake passes the required thresholds? Conversely, "relating" seems to be intended as a formula for covering factual situations where the consideration itself passes the threshold. In the above-mentioned European scenario, the choice of law seems to be determined more by the wish to escape the scrutiny of European law than by any arguments based on the economic importance of the agreement.

Arguably, in the case where the rating agreement does not stipulate for the consideration of at least $250,000, that rating agreement's choice of law clause should be regarded as invalid under NY law. Such finding would also be conclusive for the German court under s. 30 *EGBGB*.

Thus, at least in the case of smaller issuances and between the issuer and the rating agency, the choice of law clause with the rating agency would most likely be disregarded. Even if the threshold of $250,000 in consideration were passed, mandatory German law would prevail according to Art. 27 paragraph 3 of the *EGBGB*. A court might classify the case law on potential liability of appraisers as part of that mandatory law.

If the threshold of $250,000 is not passed and the NY requirements for a choice of law clause are not fulfilled, the applicable law would have to be defined by the general rule of Art. 28 *EGBGB*. According to this provision, the law of the jurisdiction to which the agreement bears the closest connection is the one that is applicable. In the case of a rating of a German issuer, this would most probably be German law since it is a mere coincidence that Moody's headquarters are in New York. This finding becomes even more obvious if it is Moody's branch in Frankfurt that has carried out the analysis leading to the rating action. Under such circumstances, the situation is more closely connected to

German law than to New York law, even if the issuance is engineered towards the international financial markets.

7.2. Qualification of the rating contract under German law

Due to the German Civil Code, contracts are qualified according to their nature and such classification has consequences for the contractual rights and duties of the contracting parties (in particular for warranties and the applicable statute of limitations). There are two possibilities for the qualification of a rating agreement, either as a "service agreement" (*Dienstvertrag*) or as a "contract for performance" (*Werkvertrag*). Under a *Dienstvertrag* the beneficiary of the services also has to pay when the result the services were intended to bring about is not achieved; in a *Werkvertrag*, however, the performance is payable only if the specific result is obtained. In a *Dienstvertrag* the payment obligation becomes due ("fällig") after the service has been rendered (see section 614 *BGB*); in a *Werkvertrag,* the payment obligation becomes due after the beneficiary has (explicitly or implicitly) accepted the performance as mainly satisfactory (acceptance, "*Abnahme*"). Thus, for example the construction of a building is only payable if the building is erected and mainly accepted, whereas a medical service is payable even if the patient dies (not due to mispractice of course).

By a rating agreement, the delivery of a rating *as such* is a result which is promised in return for payment, i.e. a rating agency will not be allowed to ask for remuneration if it has not delivered a rating *at all*. On the other hand, it is not a *specific* rating result that is promised by the rating agency, but rather, a due diligence endeavor to assign an appropriate rating. In so far, the promise to endeavor brings the arrangement closer in line with provisions on the *Dienst-*

vertrag. As far as a specific rating is concerned there is thus no result-obligation.

Lutz Krämer argues that such a contract should still qualify as a *Werkvertrag* given that there are usually review-talks which qualify as "acceptance" (*Abnahme*).[106] Personally, I do not share this view. Making a payment claim subject to an "acceptance" procedure (*Abnahme*) would hinder the independence of rating agencies in their actions. Qualifying rating agreements as subject to *Werkvertrag* law would require – in case of dispute – that the judiciary decide on the adequacy of the rating prior to the satisfaction of the rating agencies. Courts are however poorly equipped and adapted to make (*ex ante*) judgements on the adequacy of a rating. Thus, in my view, more speaks in favor of a qualification as "*Dienstvertrag*."

7.3. Recognition of rating agencies under German law

Germany used to not have any formal recognition criteria for rating agencies - unlike in the US with NRSRO-status conveyed through no-action letter. However, that changed with the implementation of the insolvency regulation. [107] BAFin now only recognizes the use of ratings from external rating agencies if they have been accepted to be used by BAFin. The criteria follow

[106] Lutz Krämer, "Aktuelle Rechtsfragen des externen Ratings, in: Internes und externes Rating, Aktuelle Entwicklungen im Recht der Kreditsicherheiten – national und international," *Schriftenreihe der Bankrechtlichen Vereinigung,* vol. 24, eds. Walther Hadding, Klaus J. Hopt and Herbert Schimansky, (Berlin: Justus-Liebig Universität: 2004), 12.
[107] Bundesanstalt für Finanzdienstleistungsaufsicht, "Anerkennung von externen Ratingagenturen für Zwecke der Risikogewichtung im Rahmen der Solvabilitätsverordnung," BA 27 – GS 4036 – 2005/0001, 20 December 2005, 1. www.*BAFin*.de/schreiben/89_2005/051220_2htm.

closely those set-up by CEBS.[108] Only if those criteria are fulfilled by a rating agencies, will its ratings be of use credit institutions to fulfill legal requirements. The recognition system has slowly been incorporated into the German law. As of April 3, 2007, only Moody's and Fitch have been universally accepted to be used by *BaFIN*.[109]

Similar recognition-systems have been established by other regulators in the field. For example, fund managers of the German social security system are bound by administrative guidance as established by the Federal Social Security Supervisory Agency ("*Bundesversicherungsamt*" BVA). While the first such decree[110] mentioned rating agencies only as most important auxiliary criterion for the determination of credit worthiness, the second decree of this type[111] prohibits investments in non-rated debt instruments:

> "According to section 80 (1) *SGB* IV a social security agent has to invest its capital such that a loss seems excluded and that an appropriate result is achieved and that sufficient liquidity is guaranteed… In order to account for the principle of security, in the view of the Bundesversicherungsamt only the investment in such securities is allowed, which have been rated by at least one recognized rating agency in one of the highest rating categories, for example from Aaa to A3 with Moody's or from AAA to A- with Standard & Poor's or Fitch. In such cases the rating of the individual security and not of the fund as such is decisive. If a rating downgrade to Baa1 to BBB+ or worse occurs, the security has to be sold.
> The rating of mutual funds is also in our view still too unreliable since the criteria for the evaluation of the various funds in parts differ greatly. Further, the rating of a fund may vary considerably through liquidity in- or outflows within a short period of time."

[108] CEBS 20 January 2006, Guidelines on the recognition of External Credit Institutions. http://www.c-ebs.org/pdfs/GL07.pdf
[109] http://www.bafin.de/auslegung/T016N001F001.htm
[110] "Schreiben des Bundesversicherungsamtes," *Geschäftszeichen* V 1 – 4060 – 2101/99, December 1, 2000, 3.
[111] "Schreiben des Bundesversicherungsamtes," *Geschäftszeichen* V 1 – 411 – 4381/2003, (December 1, 2004, September 10, 2004), 3.

Similarly, *BAFin* prohibits investments of mutual funds into certain categories and allows investing bound capital only in investment grade rated securities; exceptions have to be justified[112]:

> "If investments like listed bonds are rated according to the customs in the market, then the assessment of credit risk in the investment has to account for the recognized rating agency. These rated investments which do not dispose of an investment grade rating (long-term ratings BBB- according to Standard & Poor's and Fitch or Baa3 according to Moody's or short-term ratings A-3 according to Standard & Poor's, F 3 according to Fitch or Prime 3 according to Moody's) may only be added to the bound assets if no other supervisory regulation exists and if the insurance enterprise has valued their level of security positively in a documented manner. Such an assessment by the insurance company itself may, however, only be recognized, if the insurance company considering the character of the investment has sufficient personal and professional resources. Such investments may only supplement the portfolio to a marginal degree and under consideration of their risk tolerance. Such investments have to be diligently surveyed during their whole duration."

Last but not least, the German High Court held a bank liable to the investor of corporate bonds for either not recognizing a non-investment grade rating before making its recommendation or for not disclosing that it was unable to advise the purchaser on such bonds with the required detail and thoroughness. Reading the stock exchange prospectus was not sufficient to prove the due

[112] "Bundesanstalt für Finanzdienstleistungsaufsicht" (*BAFin*), *Rundschreiben* 29/2002 (Versicherungsaufsicht) vom December 12, 2002, Teil A: "Hinweise zur Anlage des gebundenen Vermögens von Versicherungsunternehmen" (§ 54 Abs. 1 VAG, §§ 1 ff. AnlV), Nr. I, 1, c) [translated].
http://www.*BAFin*.de/cgi-bin/*BAFin*.pl?verz=0605040000&sprache=0&filter=v&ntick=0

diligence of the bank.[113] This leading case concerned a rating which was rendered by the Australian Ratings Agency and related to bonds of the Australian Bond Group.[114]

The judiciary currently tends to require banks, if not to recommend investment opportunities only after a rating has been rendered, then at least to inform the investor of the lack of rating as indication for suspicion. The higher regional court of Nuremberg, for example, decided in a fairly recent decision that a bank which did not disclose the speculative grade rating of a foreign issuer had committed a breach of its agency relationship with the customer, making it liable for damages.[115] Thus, observation of – for the time being Moody and Fitch ratings - by the fund management industry is practically mandatory.

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[113] Bundesgerichtshof of 6.7.1993, NJW 1993, 2433 [2434] (XI ZR 12/93) [translated]:
"If all of this was not known by the investment counsellor and if he did not know of the downrating by the Australian Ratings Agency, then he should have revealed that he was unable to give sound advice to the plaintiff at time time of purchase of the bond. Instead, by giving investment advice he breached his duty to render all necessary information in a timely manner. This is particularly apparent when considering that the defendant had, through acceptance of the bond in its investment program, given the appearance of having performed his own research and assessment."

[114] Unlike the German High Court, one of the Courts of First Instance deciding on the matter found that a credit institution need not know of the rating of an internationally unknown rating agency and dismissed the suit, LG Itzehoe, decision of 26.2.1992, WM 1993, 205, (2 O 842/91):
"A credit institution need not have notice of a rating of an issuer through an internationally unkown rating agency (here: Australian Ratings Agency). Since the issuer of a bond only has to subject himself to the appraisement of his bonds through an internationally renowned rating agency if he wishes to do so, the circumstance that no appraisement exists does not constitute a risk on whose existence the client must be alerted."

[115] OLG Nürnberg *ZIP* 2002, 611.

7.4. Regulation of rating agencies under German financial law

German financial law recently has been greatly influenced by EU law and the various directives and regulation mentioned in the context of the UK have been implemented in Germany as well. *BAFin* has a similar to the FSA but the financial provisions are not assembled in one "Code" but rather in a multitude of laws each with the purpose of transposing EU law.

7.4.1. Section 34b *WpHG* / section 44 *BörsenG*

Ratings do not constitute advice and rating agencies are thus also under German law not subject to a permission procedure. The German legislator has, however, increased the protection made available to the investors by also regulating "indirect recommendations" of "financial analysts" through section 34b of the law pertaining to the trading with securities (*Wertpapierhandelsgesetz, WpHG*). Section 34b *WpHG* applies to "recommendations" and ratings are no such recommendations because they do not express a positive sentiment towards the purchase or sale of specific securities. Rather, ratings express an opinion on the creditworthiness of an issuer or a specific security and the investment in such "safe" securities may still be economically detrimental given the price at which the security is offered.

Nevertheless, section 34b *WpHG*[116] could be applicable by analogy. According to section 34b *WpHG* financial analysts' "indirect recommendations"

[116] § 34b *WpHG - Analysis of financial instruments* (translated in its pertinent part):
(1) **Persons who**, as part of their professional or business activities, **prepare information** concerning financial instruments or their issuers t**hat contains a direct or indirect recommendation** for a particular investment decision **and is intended to be made available to an unspecified group** of individuals (financial analysis), **are obliged to do so** with the

intended to be made to an unspecified group have to be prepared "with the requisite degree of expertise, care and conscientiousness" and "may only be communicated or publicly disseminated if they have been prepared and presented appropriately, and

1. the identity of the person responsible for communicating or distributing the financial analysis, as well as
2. circumstances or relationships that could produce conflicts of interest among the issuers, the legal persons responsible for preparing the analysis or undertakings associated with these

are disclosed together with the financial analysis."

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requisite degree of **expertise, care and conscientiousness**. Financial analyses may only be communicated or publicly disseminated if they have been prepared and presented appropriately, and

1. the **identity of the person responsible for communicating** or distributing the financial analysis, as well as
2. circumstances or relationships that could produce **conflicts of interest** among the issuers, the legal persons responsible for preparing the analysis or undertakings associated with these,

are disclosed together with the financial analysis.
(2) A summary of a **financial analysis prepared by a third party may only be communicated if the contents of the analysis are presented in a clear and not misleading fashion**, and if the summary makes reference to both the source document as well as the place where the disclosure pursuant to subsection (1) sentence 2, which is associated with the source document, has been made directly and easily accessible, provided this information has been publicly distributed.
(3) **Financial instruments** within the meaning of subsection (1) **are** only those which
1. are **admitted to trading** (…)
(4) The provisions given in subsections (1), (2) and (5) **do not apply for journalists** if they are subject to a system of self-regulation and effective controlling mechanisms similar to the arrangements of subsections (1), (2) and (5) as well as of section 34c.
(5) Companies which prepare or communicate financial analyses according to subsection (1) sentence 1 **have to be organized in such a way that conflicts of interest**, within in the meaning of subsection (1) sentence 2, **remain as infrequent and insignificant as possible**. In particular, they must maintain appropriate control mechanisms capable of countering any contravention of the obligations given in subsection (1).
(6) Investment services enterprises which make information available to others concerning financial instruments or their issuers that contains a direct or indirect recommendation for a particular investment decision, have to present this information with the requisite expertise, care and conscientiousness, and disclose any circumstances or relationships that could produce conflicts of interest among the issuers, the legal persons responsible for preparing the analysis or undertakings associated with these. The organizational requirements given in subsection (5) shall apply accordingly. (…)

Each of these effects applies just as well to financial analysts as to rating experts. Ratings should also be made "with the requisite degree of expertise, care and conscientiousness" and from the perspective of corporate governance it would seem desirable to have rating agencies show (1.) "the identity of the person responsible" and (2.) "circumstances or relationships that could produce conflicts of interest." However, during the legislative procedure, there was no indication that this provision should also apply to rating agencies and thus the general view is that this provision shall not apply to rating agencies.[117] The cases of analysts' recommendations and rating actions do differ somewhat however. Whereas analyst recommendations typically stem from investment banks, the three most well known (external) rating agencies Moody's, S&P and Fitch, bear no connection to credit institutions. However, other factors may make the independence of rating agencies questionable (supplementary "advisory" fees, personal relationships, etc.). Still, in order to apply a legal provision by analogy, there must be an unwanted lacuna in addition to the comparable fact pattern. Neither of the two conditions was clearly fulfilled. There is no indication as to whether the legislator wanted section 34b *WpHG* to apply to rating agencies or not, and the fact pattern is not fully comparable. Thus, section 34b *WpHG* is not applicable by analogy, at least insofar as there is no corporate connection to a financial institution trading in such securities.

Similarly, the new provision of section 31d *WpHG* implementing the MiFID requires of investment firms to disclose payments received from third parties. As section 31d will merely implement the MiFID, thus its limitations

[117] Britta Bultmann, Jürgen Witte, "Unternehmensrating – Rechtsschutz und legislativer Handlungsbedarf," in: *Grundlagen und Implikationen von Ratings für Agenturen, Investoren und geratete Unternehmen,* 3.1., eds. Ann-Kirstin Achtleitner and Oliver Everling, (Wiesbaden: Gabler Verlag), 89-132 (98).

should be applied while interpreting the provision. If MiFID specifically limits its application to investment firms rendering *invididual* advice, then again this limitation has to be followed for the interpretation of the German provision of section 31d *WpHG*. Rating agencies do not render individual advice, thus, section 31d *WpHG* should be interpreted so as to apply to rating agencies.

Also, section 44 *BörsenG*esetz which establishes prospectus liability for persons who sign responsible for the prospectus or for those by whom the prospectus is published, is not applicable to rating agencies as these do not fall under either category and remain distinct from the issuer.[118]

The *BGH* decided, however, that section 31 *WpHG*, required the disclose the amount of remuneration received by a bank from an investment fund (so-called "kick-back") if such remuneration is tied (against a fixed or variable fee) to the turnover received from the bank's recommendations[119]. If not, the bank's customer may redeem the shares to the bank against his initial consideration if the investment goes fail on the grounds that the bank has breached its duty to disclose such kick-back gratification.[120] The idea of the *BGH* is to require of the bank to allow its client to correctly gauge the potential for a conflict of interest by seeing the precise amount of kick-back gratification received.

It remains to be seen whether this jurisprudence can be applied to rating agencies by analogy although they do not formally fall under the *WpHG*.

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[118] Similarly, Gerhard C. Oellinger, "Juristische Konsequenzen bei fehlerhaften Ratings und mögliche Lösungsansätze," 357-389 in *Grundlagen und Implikationen von Ratings für Agenturen, Investoren und geratete Unternehmen,* eds. Ann-Kirstin Achtleitner and Oliver Everling, (Wiesbaden: Gabler Verlag 2005) 387.

[119] *BGH* Case n° XI ZR 56/05 as of Dec. 19, 2006, available at http://www.bundesgerichtshof.de/entscheidungen/entscheidungen.php.

[120] Eichhorn, Jochen, "Die Retros warden transparenter", Justiz und Gesetzgeber erzwingen Offenlegung von Kick-backs", FAZ 16.5.2007, S. 30.

7.4.2. Other provisions of financial law pertaining to rating agencies

Ratings are not in and of themselves considered to be insider information according to section 15 *WpHG*[121]. The new section 15 *WpHG* defines in-

[121] § 15 *WpHG*, Public disclosure and notification of inside information (translated)
(1) **Immediate public disclosure is required** from an issuer of **financial instruments** that are **admitted to trading on an organised market** within Germany, or for which it has applied for such admission, regarding all **inside information** which directly concerns that issuer. In particular, inside information directly concerns an issuer if it relates to developments within the issuer's sphere of activity. Any issuer or person acting on behalf or for the account of an issue, who as part of his function communicates or grants access to inside information for a third party, must at the same time publicly disclose the information, unless the third party is legally obliged to observe confidentiality. In the event of inadvertent communication or granting of access to inside information pursuant to sentence 3, late public disclosure must be made immediately. The key figures employed in the context of public disclosure shall be those customarily used in business and must permit comparison with previously employed figures.
(2) Other information which obviously fails to meet the requirements of subsection (1) may not be published even in connection with information subject to the disclosure requirement pursuant to subsection (1). Untrue information published pursuant to subsection (1) must be corrected immediately in a public disclosure pursuant to subsection (1) even if the requirements in subsection (1) are not met.
(3) The issuer is **exempt** from the disclosure requirement pursuant to subsection (1) sentence 1 as long as **necessary to protect its legitimate interests**, provided there is no reason to expect a misleading of the public and the issuer is able to ensure that the inside information will remain confidential. Late public disclosure must be effected immediately. Subsection (4) applies accordingly. The issuer is obliged to notify the Supervisory Authority regarding the grounds for exemption together with the notification pursuant to subsection (4) sentence 1, stating the time of the decision concerning the postponement of disclosure.
(4) Before disclosing the information referred to in subsection (1) or (2) sentence 2, the issuer shall notify

1. the management of the organised markets on which the financial instruments are admitted to trading;
2. the management of the organised markets on which derivatives are traded, which are based on the financial instruments and
3. the Supervisory Authority

Subsection (1) sentence 5 as well as subsections (2) and (3) apply accordingly. Prior to disclosure, the management may only utilise the information provided to it pursuant to sentence 1 for the purpose of making the decision as to whether or not calculation of the stock exchange price is to be suspended or discontinued. The Supervisory Authority may permit issuers domiciled abroad to effect the notification pursuant to sentence 1 together with the disclosure, provided this does not impinge upon the decision of the management concerning suspension or discontinuation of calculation of the stock exchange price. (…)

sider information as "all inside information which directly concerns that issuer," and consequently, even information which does not stem from the issuer itself but from a third party may be considered insider information. Typically, rating agencies have access to insider information but the disclosure obligation is not on them but on the issuer itself. The rating can itself constitute insider information if it conveys information not prior accessible to the public. But as of the moment of the rating decision, typically the rating is disclosed and thereby becomes public information falling outside of the sphere of insider regulation. As mentioned above, ratings do not constitute advice according to section 1 (3) no. 6 *KWG* and thus the agencies are not themselves subject to banking regulation. In sum, rating agencies are unregulated entities under German law.

Nevertheless, banks and other financial institutions are legally bound to observe ratings as a criterion to evaluate the credit-worthiness of an issuer (see Section 7.3. Recognition of rating agencies under German law).

7.5. Liability under German law

Until now, no German court has ever dealt explicitly with the question of the potential liability of rating agencies for their actions. A solution to the question has, thus, still to be derived from the existing body of law. In the context of a Civil Code system, the starting point is statutory law. European law has not yet been of any assistance in this regard; the prospectus directive (EC Nr. L 124/8 of 5.5.1985) does not cover the question of liability of rating agencies. A proposal for a new directive dealing with the sensitive question of the liability of rating agencies is currently being discussed by the EU Commission,

but under existing law the question is entirely subject to the law of individual member states.

It will be shown that under existing German law:

- a waiver of liability clause will probably be deemed invalid by the courts (1),
- courts will probably find the contract of the issuer and the rating agency to be to the benefit of the investors with the consequence that contractual liability applies (2),
- and that rating agencies might also be found liable under tort principles (3).

7.5.1. Invalid waiver of liability

Most rating agreements include a waiver of liability clause. Fitch's general agreements, for example, contain the following clause:

> "Fitch IBCA Ltd. has used due care in the preparation of this document. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. Fitch IBCA Ltd. shall owe no liability whatsoever to any person for any loss or damage caused by or resulting from any error in such information."

Similarly Moody's Terms of Agreement state:

> "All information furnished pursuant to this Agreement is obtained by Moody's from sources believed by it to be accurate and reliable. Because of the possibility of human and mechanical error as well as other factors, however, all information is provided "as is" without warranty of any kind and Moody's in particular, makes no representation or warranty, express or implied, to subscribers or any other person or entity as to the accuracy, timeliness, completeness, merchantability of fitness for any particular purpose of any such information. Under no circumstance shall Moody's have any liability to subscribers or any other person or entity for (a) any loss, damage or other injury in whole or in part caused

> by, resulting from, or relating to, any error (negligent or otherwise), or any other circumstance or contingency within or outside the control of Moody's or any of its directors, officers, employees or agents, in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any information, or (b) any direct, indirect, special, consequential, incidental or compensatory damages whatsoever (including, without limitation, lost profits), even if Moody's shall have been advised in advance of the possibility of such damages, in either case caused by, resulting from or relating to the use of, or inability to use, any information."

Such an exemption under German law – if found applicable - would, however, probably not hold. The agreements rating agencies use are prepared for a large number of contracts and are thus subject to the German content control provisions for standard contract terms (s. 305-310 *BGB*).

Under s. 309 nr. 9b) *BGB*, a clause allowing for an exemption of liability is invalid if it pertains to gross negligence or intent. The clauses used by rating agencies typically do not restrict their waiver to mere negligence. Under German case law, a clause in a general agreement containing invalid parts and valid parts may not be limited to its valid parts. If the content-control leads to the finding that a part of a clause is invalid, then the whole clause is to be treated as invalid (so-called "prohibition of validity sustaining interpretation"[122]).

Furthermore, the German High Court ruled in a recent decision that an expert opinion that is obviously used to induce the reliance of some other third party (for example, the buyer of real estate) will be seen as benefiting this other third party and that any clause trying to exclude such liability is void for rea-

[122] Cf. for ex. BGHZ 86, 285 [297] (VII ZR 105/81 as of 20.1.1983).

sons of good faith.[123] In one such case, a seller hired an expert to render an appraisal opinion on the value of real estate for "purposes of planning and financing." The appraiser was informed as well, that the appraisal was to be completed for that specific purpose.

This knowledge was sufficient for the German High Court to decide that the lower courts had wrongfully rejected liability based on third party beneficiary law. The appraisal expert typically knows that his opinion will be used by the vendor to induce the reliance of third parties and it is on the basis of equity that the German High Court argues in favor of the expert's liability.

This argument could, however, similarly be made in the case of rating agencies. The issuer [vendor] of securities asks a rating agency [appraisal expert] to render an opinion on the financial status and both the issuer and the agency know that the rating will be used for contract negotiations vis-à-vis third parties.

The German High Court's decisions in this regard are numerous, especially in regards to appraisal opinions. A waiver would, under such circumstances, be disregarded under the good faith argument of *venire contra factum proprium* (conflicting behavior).[124] No rater of securities may, on the one hand, act as if his rating has been performed for the purposes of informing the investors but deny any responsibility if such a rating turns out to be wrong. The due

[123] Bundesgerichtshof vol. 20.4.2004, *NJW* 2004, 3034-3039 [3035] (X ZR 250/02), [translated]: "Furthermore it is recognized that experts who work as appraisers without public mandate are also liable according to the principles of contract to the benefit of third parties not just towards their contracting party but also towards third parties for the accuracy of their appraisal, if the mandate to render their appraisal opinion according to the contractual intentions included the protection of third parties (Senat, NJW 2001, 514 [516] = NZM 2001, 253; Staudinger/Jagmann, *BGB*, Neubearb. 2001, s. 328 Rdnr. 139). An appraisal opinion that is intentionally presented to third parties as a basis for their investment in relation to the client generally comprises the protection of such third party; a conflicting intention of the client and the appraiser with the intention to defraud the third party is *mala fide* and, therefore, irrelevant."

[124] This rule has been integrated into the German body of law and has its origins in Roman law. It can be paraphrased as "Nobody may pretend to act against his own declarations."

diligence assessment of the probability of default belongs to the primary obligation (*Kardinalpflicht*) of the rating agencies and under the principles of German law the general view is that it is impossible to exclude liability for the defective performance of primary obligations.[125]

On its website, Moody's, for example, presents itself as "a leading provider of independent credit ratings, research and financial information to the capital markets"; Moody's cannot, therefore, with respect to German appraisal cases, validly exclude its liability if the ratings the company provides turn out to be misleading.[126]

7.5.2. Contractual liability under the theory of contract to the benefit of third parties

Rating agencies do not conclude contracts with investors. However, under German law, in much the same way as under US contract law principles, it is recognized that contracts can exist to the benefit of third parties.

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[125] Cf. Johannes Fiala and Christian Kohrs, "Verantwortlichkiet und Haftung einer Ratinggesellschaft gegenüber Dritten am Beispiel des Versicherungsratings," in: *Rechtsfragen im Rating, Grundlagen und Implikationen von Ratings für Agenturen, Investoren und geratete Unternehmen,* eds. Ann-Kristin Achtleitner and Oliver Everling, (Wiesbaden: Gabler Verlag 2005), 341-355, 346.

[126] Similarly, Gerhard C. Oellinger, "Juristische Konsequenzen bei fehlerhaften Ratings und mögliche Lösungsansätze," in: *Rechtsfragen im Rating, Grundlagen und Implikationen von Ratings für Agenturen, Investoren und geratete Unternehmen,* eds. Ann-Kirstin Achtleitner and Oliver Everling, (Wiesbaden: Gabler Verlag 2005), 357-389 (386).

7.5.2.1. Classification of third party beneficiary agreements

German doctrine differentiates between three types of contracts with regard to third parties.

- "real contracts in favor of third parties," section 328 para. I *BGB* (direct right of claim to the benefit of a third party)
- "unreal contract to the benefit of third parties," section 328 para. II *BGB* (indirect benefit for third party but no direct right of claim of third party)
- "contract with effect of third party protection,"[127] sections 328 para. I, 241 para. II *BGB* by analogy (third party benefits only from pecuniary remedies in case of breach but may not claim specific enforcement)

The most direct benefit to the third party exists where the third party has a direct right of claim (section 328 para. I *BGB*).[128] Interpretation decides whether a contract benefiting a third party confers a direct claim to such third party or not.[129] The theory of contracts to the protection of third parties ("*Vertrag mit Schutzwirkung zu Gunsten Dritter* ") has been developed by analogy to these provisions. This form of contract entails no right to the primary obligation but renders the obligor liable to the third party for all pecuniary damage caused by his breach of accessory fiduciary obligations (s. 280, 278 I *BGB*).

[127] *Vertrag mit Schutzwirkung zu Gunsten Dritte*.
[128] *Echter Vertrag zu Gunsten Dritter.*
[129] The latter form is called *unechter Vertrag zu Gunsten Dritter* in German, s. 328 para. II *BGB*.

7.5.2.2. Advantages of third party beneficiary law vis-à-vis tort law

The general tort principles of German law are codified in sections 823 et seq. Both academia and courts consider these provisions to be insufficient. Under the central provision of section 823 para. I *BGB*, even negligent conduct will not lead to liability unless a so-called absolute right has been violated.[130] These are rights that may be averred to everybody, for example, real property rights, life, and honor etc. The mere interest in protecting one's wealth and respecting contractual relationships is not considered an absolute right.

However, many damages, although not arising from such violations and causing pecuniary damage, seem to justify reparations for reasons of equity. In order to avoid such inequities, the jurisprudence has, therefore, enlarged the field of contractual liability by inventing the pre-contractual form of liability called *culpa in contrahendo* (similar to the doctrine of reliance under common law) and by interpreting agreements to be to the benefit of third parties. Last but not least, the judiciary has combined pre-contractual liability with third party beneficiary principles.

One leading case in this area concerned a child that fell on a leaf of lettuce in a supermarket while accompanying her mother.[131] The German High Court argued that it did not matter who slipped on the leaf of lettuce - mother or child - even though the child herself had no intention of forming a contract with the supermarket. From the fiduciary relationship between the mother and the child,[132] the court argued that the supermarket was aware that upon the custom-

[130] Unlike the French *Code Civil* (s. 1382), the German tort principles (s. 823 *BGB* et seq.) generally limit recovery to cases of damage to so-called absolute rights.
[131] BGHZ 66, 51 *Lettuce case (Gemüseblattfall)* (VIII ZR 246/74 as of 28.1.1976).
[132] In German "Wohl und Wehe," these old German words may be translated as "relationship for good and bad"- times.

ers' entrance into the supermarket it should have protected the child as well as the mother.

Initially, the judiciary limited the pre-contractual liability to the benefit of third parties to family relationships. Soon, however, that limitation was abandoned. Other fiduciary situations, the employer and the employee for example, also seemed to warrant the application of third party beneficiary law. Last but not least, the judiciary also decided that agents could be liable for misrepresentations to third parties relying on such misrepresentation,[133] if the agent had assumed personal trust and thereby induced reliance.[134] A leading case in this evolution was the "Consul-case": A publicly installed appraiser for realties had rendered his opinion. Four months after this opinion, the Danish consul asked the appraiser if his assessment was still accurate. The appraiser confirmed both by telephone as well as in writing. Thereafter, a Danish bank lent the owner the monies but never received repayment of principal. It turned out that the value of the realty was much less than the appraised value. The Supreme Court decided that the appraiser was responsible on grounds of contract with third-party benefit.[135]

This latter form of agent liability became a general form a liability for third parties assuming expert status on which others justifiably rely.[136] With effect of January 1, 2002, these principles of third party beneficiary law were formally recognized by the Act for the Modernization of the Law on Obligations and are now contained in section 311 paragraphs 2 and 3 of the *BGB*.[137]

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[133] *Sachwalterhaftung* – liability for assumed trust.
[134] For example in BGHZ 126, 181 (II ZR 292/91 as of 6.6.1994).
[135] *BGH* JZ 1985, 951 (as of 23.1.1985), cf. C.J.H. Jansen and A.J. van der Lely, "Haftung für Auskünfte; ein Vergleich zwischen englischem, deutschem und niederländischem Recht," *ZEuP* 1999, 229 (235).
[136] As such there are similarities to the American doctrine of promissory estoppel and detrimental reliance.
[137] [Translated]

The two main advantages of applying contract principles rather than tort principles relate to, among other things, the contractual presumption of fault according to section 280, para. I, sentence 1 *BGB* and the imputation of an agent's fault in the course of performance (s. 278, para. I, sent. 1 *BGB*). Under the principles of a contract for the protection of a third party, the third party has no relationship to the primary obligation (in the case of a purchase, no right to claim delivery or payment), but may benefit from a right to claim damages in case its interests are not protected by the obligor in the course of performance.[138]

Section 311 *BGB*:
(1) In order to found a relationship of obligations through a legal transaction, a contract is needed. A contract is also needed for the change of content of such a relationship if the law does not prescribe some other means of foundation.
(2) A relationship of obligations with duties according to s. 241 para. 2 is also founded through
1. the initiation of contract negotiations,
2. the initiation of a contract in which one party allows the other to influence his right, objects or interests, or entrusts such right, objects or interests.
3. comparable business contracts.
(3) A relationship of obligations with duties according to s. 241 para. 2 may also exist to persons that shall not become contracting parties themselves. Such a relationship may arise in particular if the third party claims the trust and reliance of the other party ("in besonderem Maße Vertrauen für sich in Anspruch nimmt") and thereby significantly influences the contract negotiations or the signing.

[138] All three types of third-party beneficiary relationships may contain such obligations to protect and care for the interests of third party; Huber and Faust clarify that s. 311 para. III *BGB* applies to all three variations; Huber and Faust, *Schuldrechtsmodernisierung, Einführung in das neue Recht,* (München 2002), chapter 3, section no. 12, 71. clarify that s. 311 para. III *BGB* applies to all three variations.

7.5.2.3. Conditions of third party beneficiary law

The conditions for inclusion in the zone of contractual protection are the following:

1. Risk proximity[139]: the third party must be subject to the same risks arising out of the contract as the creditor to the agreement

2. Creditor proximity[140]: the creditor, because of family ties or for other reasons, is intent on including the third party in the effects of protection resulting from the agreement. To prove such intent, the judiciary employs the argument of good faith.

3. Recognizability[141]: The debtor can recognize both the risks arising to the third party and the interests of the creditor to include this party

4. Need for protection[142]: Finally, the third party must not already have a contractual claim against the obligor.

These conditions have been further specified by doctrine and case law for expert liability to third parties. Heukamp has identified the following conditions necessary to fulfilling the requirements of third party beneficiary law in expert liability cases:[143]

1. one of the contractual parties possesses specific, publicly acknowledged competence,
2. expert opinion has been requested in order that it may be used vis-à-vis third parties,

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[139] *Gefahrennähe.*
[140] *Gläubigernähe.*
[141] *Erkennbarkeit.*
[142] *Schutzbedürftigkeit.*
[143] Wessel Heukamp, "Brauchen wir eine kapitalmarktrechtliche Dritthaftung von Wirtschaftsprüfern?," *ZHR* 169 (2005), 471-494 [477] [translated].

3. and the certifying expert could foresee that his opinion would be used in such way.

If a certified public accountant (*Wirtschaftsprüfer*) conducts his business under these conditions, he thereby implicitly agrees to control the financial data diligently and conscientiously and to do so in the interests of concerned third parties. The Bundesgerichtshof specified in a very recent decision that the interpretation of third party beneficiary law would have to follow the intention of the legislator expressed in section 323 I sentence 3 *HGB*, which limits liability for audits to the company audited and to the amount of €1 million. Thus, in order to delimitate potential liability of auditors in that case, the Bundesgerichtshof refused to accept liability of auditors if they had no awareness of a later use of the audit opinion for a private purchase (the audit had been prepared at a stage when an IPO was planned) and if no private contact with the auditors had been established.[144] That decision should, on the other hand, not have consequences in the application of third party beneficiary law to rating agencies: Neither is section 323 I sentence 3 *HGB* applicable to rating agencies, nor is an initial rating done without awareness of the later use of the rating for the general public. Only a private rating done merely for the information of the issuer without use by the general public would be most likely to fall under this recent and more restrictive approach by the Bundesgerichtshof. The application of third party beneficiary law to the case of rating agencies has thus to be deduced from general principles.

[144] Bundesgerichtshof in Haarmann Hemmelrath Wirtschaftsprüfer III ZR 256/04 v. 6.4.2006 (available at www.bundesgerichtshof.de; cf. *Frankfurter Allgemeine Zeitung*, April 10, 2006, no. 108, 25).

7.5.2.4. Application to the case of rating agencies

So far, the German courts have not decided on the liability of rating agencies. However, if a decision is to be made it is likely that the German courts would apply the principles of third party beneficiary law. The investors face even greater risk than the issuer (1.) and the courts will probably assume that the issuer, for reasons of good faith, will want the investors to be protected by the rating agreement (2.). Unlike public authorities whose purpose it is to act in the general interest of the public as a whole, rating agencies' appraisals serve the purpose of investors exclusively. They may thereby render a public service but they are not precluded from the investors as are the public authorities controlling banks or exchanges.[145]

The rating agencies would be in a position to notice the risks arising to the investors (1.) and hold themselves out as protectors of the interests of investors (3.). No other contractual tie exists for the investor to directly sue the rating agency and investors would have to seek the protection of the rating agreement (4.): Under tort law, they would, in most instances, not be able to seek any remedy. Section 823 I *BGB* would not be considered applicable if a wrongful rating induced a worthless investment because wealth as such is not protected under tort principles.[146]

[145] Compare at least in the context of the analysis of rating agencies under German law, the decision of the European Court of Justice of October 12, 2004, *NJW* 2004, 3479 (for banking supervisory authorities); and Landgericht Frankfurt am Main, of September 3, 2004, *ZIP* 2005, 169 (for the exchange admission bureau of the Land Hessen, Börsenzulassungsstelle).

[146] For Dieter Medicus, *Bürgerliches Recht*, 18th ed., (München: Beck Verlag 1999), Section 199, wrongful information is stated as a prime example for the applicability of the principles of contract to the benefit of third party law instead of the application of tort principles.

Under such principles of third party beneficiary law, in the event of any breach, negligence would be presumed pursuant to s. 280 *BGB*, and claimants would only have to prove

1. the contract between the rating agency and
2. that the information contained in the rating action was wrongful (breach).

Generally, courts have been rather reticent about accepting inclusions relating to contract protection for the benefit of third parties. The German High Court has found, however, that contracts with experts are presumed to serve the interests of third parties if the expert opinion was obviously intended to serve third parties and the expert, through some sort of recognition, assumes authority for his statements.[147] In a recent case the German High Court concluded that the appraisal contract between a fund and a certified public accountant (*Wirtschaftsprüfer*) that had given a warranty for the accuracy of the sales prospectus was indeed a contract to the benefit of the investors.[148] The investors could, therefore, in the opinion of the High Court, not only base their legal action on torts but also on contract law and thereby benefit from a more favorable regime under the statute of limitations (another benefit of contract law).

[147] Palandt-Heinrichs, commentary to the *BGB*, s. 328 no. 34.

[148] *BGH* 8.6.2004, NJW 2004, 3420-3423 [3421] (X ZR 283/02): "According to the constant ruling practice of the *BGH* in particular persons who possess a special know-how that is recognized by the government and who, acting in this character, render an appraisal or an opinion of appraisal, such as publicly nominated experts, public accountants and tax advisors, may become liable to third parties if their client makes the intended use of the appraisal opinion (continuous ruling practice of the *BGH*; for example, senate ruling, BGHZ 145, 187 [197] = NJW 2001, 360, and *BGH*, NJW 2004, 3035 (X ZR 250/02) [under letter II 1 a of that decision]). Such conditions are seen as having been fulfilled in cases in which a firm of accountants has verified the content of a sales prospectus for an investment on behalf of the initiators of such investment and where such firm has testified the completeness, accuracy, plausibility and credibility, and when it was known to such a firm that its appraisal opinion would be presented to interested persons in order to motivate them to make an investment in the fund company."

In this context it does not matter if the interests of the two parties, from whose (presumed) intention the protection of third parties is derived, are contrary to each other.[149] In fact, therein lays one of the main points of critique by doctrinal writers of this jurisprudential analysis. Is it not mere fiction to say that a vendor intends to obtain a fair and diligent appraisal in order to protect potential buyers? Would he not prefer some exaggeration on the part of the appraiser? In many cases it is therefore not through the process of interpretation, but rather out of equity considerations that the courts apply contracts to the benefit of third party law even if the interests of the creditor and the third party are strictly opposed. Imagine, for example, an owner of realty who orders an appraisal statement on the value of his property to be used during the selling negotiations. Such a vendor would want the appraisal value to be as high as possible, whereas a potential purchaser would prefer to base the negotiations on an appraisal value that is as low as possible.[150]

Huber and Faust argue that the liability of appraisal experts, for example, is not derived from a contract between the owner and the expert, but that such liability is *sui generis* and may result directly from s. 311, para. III, sent. 2 *BGB*. According to section 311, sentence 2, *BGB* a relationship with duties to respect the pecuniary interests of others will arise in particular, if the third party claims the trust and reliance of the other party ("in besonderem Maße Vertrauen

[149] Similar with respect to this particular point, Klaus Rotter, Thomas Kremer, "Anlegerschutz und Rating," in: *Rechtsfragen im Rating, Grundlagen und Implikationen von Ratings für Agenturen, Investoren und geratete Unternehmen*, eds. Ann-Kristin Achtleitner and Oliver Everling, (Wiesbaden: Gabler Verlag 2005), 327-340, 336.

[150] This example is drawn from Peter Huber / Florian Faust, "Schuldrechtsmodernisierung, Einführung in das neue Recht," (München: Beck Verlag, 2002), chapter 3, section 12, 72.

für sich in Anspruch nimmt") and significantly thereby influences the contract negotiations or the signing.[151]

If Huber's argument as such were to be followed by the courts, rating agencies could potential be held liable under contractual principles even in the absence of a contract with the issuer ("unsolicited rating"). Some arguments favor Huber's analysis. In fact, in an appraisal situation it does seem inaccurate to conclude that a vendor would have urged the expert to state only the adequate price in order to provide for the interests of potential buyers. Such an interpretation might comply with the good faith provision (s. 242 *BGB*), but has little to do with the economic incentives of the buyer and the seller.

Furthermore, an investor/buyer might not even know whether the seller initiated the appraisal opinion. In the case of rating agencies the buyer of securities might not even know if the rating was solicited or unsolicited, or might not understand the meaning of these terms. The buyer of a security will want to rely on the rating itself, regardless of the circumstances giving rise to its rendering. The new provision of s. 839a *BGB* might also be cited as providing further support in favor of Huber's line of argument. Under this tort provision, a judicially appointed expert would be found liable in the case of gross negligence. It might be argued that section 839a *BGB* is applicable by analogy to non-judicial experts as well, or that the provision shows that expert liability has nothing to do with the law on contracts to the benefit of third parties.

However tempting these arguments might be, with regard to severing the liability of appraisal experts from the contract with the seller, the Ger-

[151] Section 311 *BGB*:
(3) A relationship of obligations with duties according to s. 241 para. 2 may also exist to persons that will not become contracting parties themselves. Such a relationship may arise in particular, if the third party party claims the trust and reliance of the other party ("in besonderem Maße Vertrauen für sich in Anspruch nimmt") and thereby significantly influences the contract negotiations or the signing."

man High Court has not changed its views in light of the Act for the Modernization the Law of Obligations and the new provisions of s. 311, para. III, sent. 2 and s. 839a *BGB*. The court has continued to use the "contract to the benefit" argument with respect to the appraisal experts.[152] The German High Court's position on deriving the expert's liability from a third party beneficiary agreement would also seem to be more convincing. Despite its weaknesses, third party beneficiary law has, through case law, developed conditions pertaining to its application which make its results predictable. This body of law is also more appropriate than a liability *sui generis* because the third party is subject to the same defenses as the primary creditor to the agreement (s. 334 *BGB*).

In the case of ratings, the rating agency may argue, for example, at least as an exception to be raised against to the investor, that it has operated merely on the basis of the information supplied and that it has not done its own data collection before the beginning of the rating procedures. Such a limitation might not be a valid defense against tort actions.

Admittedly, in the case of its application to ratings, these conditions of third party beneficiary law are somewhat imprecise. In particular, the element of recognizability seems somewhat vague in the case of capital markets. Who exactly will be protected? Only the buyer of securities who knows about the rating, or every buyer without regard to individual reliance? What time frame is applicable? Is a buyer also protected if he possesses particular skills that would enable him to see the relative falsity of the rating action? Rotter and Kremer argue that the rating would generally be addressed *ad incertas persona,* and to apply third party beneficiary law would lead to third-party beneficiary law becoming discretionary and indefinite. On the other hand, if third party benefici-

[152] This recent decision was cited earlier in the analysis to show that a waiver of liability would be deemed invalid under German law, Bundesgerichtshof v. 20.4.2004, *NJW* 2004, 3034-3039 [3035] (X ZR 250/02).

ary law were not applied, there would, despite the existence of a contract and assuming soliciting issuers would not seek the protection of the courts, be no contractual control. Since tort law offers only insufficient remedies against defective statements, without third-party beneficiary law, there would be no judicial remedy at all. This would be the case even though ratings are specifically targeted at investors and, at least economically speaking, rating agencies are responsible for the economic harm resulting from defective ratings. The aim to protect rating agencies from frivolous litigation and limit litigation to the few warranted cases should thus be sought after according to specific parameters for the duty of care and be applied by the rating agencies rather than through the denial of an effective course of action *ab initio*. Rotter and Kremers argument that a third party beneficiary should not be applied where the expert opinion is addressed *ad incertas personas* while having much validity must, however, lead to the denial of effective courses of action.[153]

If capital markets are efficient, individual reliance on a rating should not be required (cf. section 5.1.2.). So far, German law has not explicitly stated the fraud on the market theory; however, stock market law presumes causality of a sale's prospectus for the purchase or sale of securities. Under general non-statutory prospectus, the judiciary has, according to general non-statutory prospectus liability principles, found that investors fulfilled their causality-pleading requirements if they proved "an investment mood"[154] was created by the prospectus.[155]

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[153] Klaus Rotter and Thomas Kremer also have to admit this: Klaus Rotter and Thomas Kremer, "Anlegerschutz und Rating," in: *Rechtsfragen im Rating, Grundlagen und Implikationen von Ratings für Agenturen, Investoren und geratete Unternehmen*, ed. Ann-Kristin Achtleitner and Oliver Everling, (Wiesbaden: Gabler Verlag, 2005), 327-340, 339.
[154] *Anlagestimmung.*
[155] Oberlandesgericht Frankfurt am Main, *WM* 1996, 1216 [1219] (21 U 92/95 as of 27.3.1996).

Many elements of third party beneficiary law seem to require some adaptation in the case of ratings. The application of the fraud on the market theory is just one example in which the traditional condition of individual reliance and causality do not make sense.

Unlike under US law, German courts will, under third party beneficiary law,[156] almost certainly consider rating agencies to be liable for a rating that was not justifiable by the underlying data. In the absence of a contract between the issuer and the rating agency, however, only tort law seems applicable. A general liability for assumed trust-theory should be denied. There are more arguments in favor of keeping the expert's liability accessory to the contract between himself and the vendor.

7.5.3. Liability under tort law

Under principles of tort law, statutory prospectus liability is the theory to be considered first. Since prospectus liability will turn out to be unlikely in the case of rating agencies (

[156] Andreas Meyer, "Aspekte einer Reform der Prospekthaftung, Eine Würdigung der Verhandlungen des 64. Deutschen Juristentages," *WM* 2003, 1301-1348 (1310); similarly, Gerhard C. Oellinger, "Juristische Konsequenzen bei fehlerhaften Ratings und mögliche Lösungsansätze," in: *Grundlagen und Implikationen von Ratings für Agenturen, Investoren und geratete Unternehmen,* eds. Ann-Kirstin Achtleitner and Oliver Everling, (Wiesbaden: Gabler Verlag, 2005), 357-389, 381 et seq.

7.5.3.1. Statutory prospectus liability), general tort principles will be considered (7.5.3.2. General liability under tort law).

7.5.3.1. Statutory prospectus liability

Liability for wrongful information material is mandated by s. 45 para. 1 of German stock exchange law (eventually in combination with s. 13 of the law on sale's prospectuses). Prospectus information is not limited to facts, but may contain prognostic information or opinions.[157] Opinions[158] are wrongful if they cannot be justified by the underlying facts.[159] Section 45 of stock exchange law, however, limits liability to those that have assumed responsibility (for the content of the prospectus), or to those authors who initiated the issue of the prospectus.[160] Rating agencies do not fall under either category because they are not actively involved in the selling of the rated security. Their services are purely passive; a view that is supported by the judiciary.

The German High Court was required to decide on a case in which the prospectus was inaccurate and the expert had rendered an opinion. The frustrated investor sued the expert on the grounds of prospectus liability. Since section 45 of stock exchange law was inapplicable due to the kind of investment in question, it was only the application of the general principles of prospectus liability that was at stake.

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[157] "*Tatsachen, Prognosen und Werturteile*," cf. Gebauer, "Erläuterungen zum Verkaufsprospektgesetz und zur Verkaufsprospektverordnung," *Stefan Gebauer*, Wertpapierverkaufsprospekte in *Kapitalmarktrecht, Handbuch für die Praxis*, vol. 1, eds. Siegfried Kümpel, Horst Hammen, Jens Ekkenga, 67; Landgericht Frankfurt am Main 1992, WuB I G 9 1.93 = WM 92, 1768 (Bond Finance Ltd., 3/11 O 173/91): "The notion of "statement" in section 45 of the law on exchanges also comprises statements of opinion on the economic situation of an entreprise."

[158] *Werturteile* – literally judgements on value.

[159] Stefan Gebauer, "Erläuterungen zum Verkaufsprospektgesetz und zur Verkaufsprospektverordnung," Wertpapierverkaufsprospekte in: *Kapitalmarktrecht, Handbuch für die Praxis*, vol. 1, eds. Kümpel, Siegfried / Hammen, Horst / Ekkenga, Jens, (Berlin: Ericht Schmidt Verlag), 67.

[160] *von denen der Erlass des Prospekts ausgeht.*

The German High Court held that an expert's opinion does not render the expert liable under general prospectus liability principles,[161] even if the expert's opinion was the basis for the information contained in the prospectus. The expert would only become liable under prospectus liability principles if he appeared before third parties in the initiation of the prospectus.[162] Rating agencies, like lawyers, consultants and certified public accountants, never sign or appear responsible for the entire prospectus and are thus excluded from prospectus liability.[163] Liability under the stock exchange law is thus generally precluded; unless the prospectus contains specific quotes and references from the expert opinion, which is rather unlikely, German courts will not consider stock exchange law as a basis for potential action against rating agencies.[164]

A new section, section 44a of stock exchange law was, however, brought before the German parliament in the proposal for a law for liability for wrongful information relating to the capital markets (Kapitalinformationshaftungsgesetz – KapInHaG). This section would have installed a third party liability provision similar to Rule 10b-5 of the (US) Securities and Exchange Act but would have limited such liability to the amount of €4,000,000. However, the proposal for the KapInHaG was abolished by the principle of discontinuity when the German parliament was dissolved in September 2005.[165]

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[161] *Prospekthaftungsgrundsätze.*

[162] *BGH* 14. April 1986, WM 1986, 904 = WuB I G 9 Prospekthaftung 4.86.

[163] Cf. Wessel Heukamp, "Brauchen wir eine kapitalmarktrechtliche Dritthaftung von Wirtschaftsprüfern?," *ZHR* 169 (2005), 471-494 (474).

[164] Whether experts may be held liable under stock exchange law or uncodified principles of prospectus liability for their specific contribution to a prospectus is heavily disputed. Cf. Wessel Heukamp, "Brauchen wir eine kapitalmarktrechtliche Dritthaftung von Wirtschaftsprüfern?," *ZHR* 169 (2005), 471-494 (475).

[165] For further information on the proposed law, please refer to Wessel Heukamp, "Brauchen wir eine kapitalmarktrechtliche Dritthaftung von Wirtschaftsprüfern?," *ZHR* 169, 2005, 471-494 (478-479).

7.5.3.2. General liability under tort law

Liability under contract or tort principles is not precluded under the German stock exchange law (s. 47 para. II *BörsenG*esetz).

7.5.3.3. Section 824 BGB – wrongful statement on another person's credit

Section 824 *BGB* renders a person liable for dissipating a wrongful statement that could eventually endanger another person's credit if the person dissipating such a statement should have been aware of its falsity.

Generally, ratings contain a prognosis about the future creditworthiness of an issuer. As such, they resemble opinions more so than factual statements. Under exceptional circumstances (which have already been indicated above -cf. Section 5.1.2. – Fraud on the market-theory and the presumption of reliance), an opinion may contain a factual assertion. The applicability of section 824 *BGB* will, thus, depend on such circumstances; in typical rating situations it seems, however, very unlikely that courts would consider the case under section 824 *BGB*.

7.5.3.4. Section 823 para. I BGB – the right to a going concern

The general tort liability section is section 823 para. I *BGB*. Pecuniary interests as such are not protected unless caused by the injury of a so-called absolute right (property, body, life, honor, etc.). The section lists a number of such absolute rights but does not extensively address the protection of "other rights."

The German High Court has, however, come to recognize that business' right to function as a going concern could constitute such an absolute right.[166]

With respect to the risk of an unlimited expansion of this general tort statute, the German High Court required immediacy of the injury.[167] However, in doing so, the Court expounded what would be more of a normative principle than a clear-cut definition. It defines *Unmittelbarkeit* (immediacy) with the following words:[168]

> "Immediate injuries of the right to a going concern of a business, for which section 823 para. 1 grants protection, are only such injuries, which somehow are directed against the business as such, are therefore related to the business and are not simply related to detachable rights or interests of such business."

In the case of ratings, an unjustifiably negative rating is detrimental to the rated business. The rated company may thus invoke the violation of a person's right to a going concern business.[169] Usually, however, the rated company also has a contractual relationship with the issuer. The option to claim the application of s. 823 para. I *BGB* will thus prove interesting only in the case of an unsolicited rating.

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[166] BGHZ 29, 65 (VI ZR 199/57 as of 9.12.1958) recognizing the so-called *Recht am eingerichteten und ausgeübten Gewerbebetrieb* = right pertaining to the going concern of a business venture.

[167] *Unmittelbarkeit des Eingriffs.*

[168] Bundesgerichtshof in BGHZ 29, 65 (VI ZR 199/57 as of December 9, 1958): "Unmittelbare Eingriffe in das Recht am bestehenden Gewerbebetrieb, gegen welche s. 823 I *BGB* Schutz gewährt, sind nur diejenigen, die irgendwie gegen den Betrieb als solchen gerichtet, also betriebsbezogen sind und nicht vom Gewerbebetrieb ohne weiteres ablösbare Rechte oder Rechtsgüter betreffen."

[169] In support of this view, Däubler, Wolfgang, "Wer kontrolliert die Rating-Agenturen," *NJW* 2003, 1096 (1097).

As for the investors, it is typically the case that their stakes in the rated company are diversified. Investors are not immediately affected negatively if the company's bonds are rated exceedingly low. Therefore, even an unjustifiably poor rating after the securities have been bought/sold will not lead to a claim for damages under section 823, para. I, *BGB*.

7.5.3.5. Section 826 BGB

Section 826 *BGB* – unlike section 823 para. I *BGB* – provides remedies in the case of mere pecuniary damages (not pertaining to the violation of an absolute right). This section is, however, limited to actions deemed contrary to good faith. Section 826 *BGB* reads:

> "A person who intentionally causes damages to another party in a way that is contrary to public policy, will be liable for damages to this other party."[170]

The German High Court has already found that advice or an expert opinion that is the result of gross negligence[171] and has been rendered in the knowledge of potential harm will be judged as an action contra *bonos mores*. This will hold particularly if the advice or expert opinion has been rendered without proper research (i.e. just drawn out of the hat[172]) and if the author of such a statement claimed particular competence for himself.[173] Rating agencies all claim such competence and know that investors will rely on their rating. For

[170] § 826 *BGB*:
"Wer in einer gegen die guten Sitten verstoßenden Weise einem anderen vorsätzlich Schaden zufügt, ist dem anderen zum Ersatze des Schadens verpflichtet."
[171] Bundesgerichtshof, 14. April 1986, WM 1986, 904 = WuB I G 9 Prospekthaftung 4.86.
[172] In German: *Angaben ins Blaue hinein.*
[173] Palandt – Thomas, commentary to the *BGB*, s. 826, no. 25.

that reason they should be fully aware of the potential harm to the investors. A wrongful rating will, however, only qualify as having been rendered in an unconscionable manner if the rating is the result of gross negligence.

7.6. Conclusion for German law

German law will be applicable only in cases where either no choice of law clause exists, or where the choice of NY law is invalid due to the low fee consideration at stake (below $250,000). If German law were applicable, German courts would probably view a waiver of liability of rating agencies as being contrary to good faith and thus invalid. They would more likely favor contractual liability under principles of third party beneficiary law.[174] Individual reliance should not be required under the fraud-on-the-market theory.

If the rating is unsolicited, only liability under general tort principles seems possible. Liability for wrongful statements will not generally be incurred, however, since in most cases ratings do not contain a factual assertion. The rated business may, on the other hand, claim damages under s. 823 *BGB* by arguing that a wrongful rating violated its right to the going concern (*das Recht am Eingerichteten und Ausgeübten Gewerbebetrieb).* Investors relying on a wrongful rating will only be able to claim damages if the rating is the result of gross negligence. In the case of solicited ratings German courts will thus probably find rating agencies liable for mere negligence; if the rating is unsolicited, gross negligence must be proven by the plaintiff.

As is the case for American courts, German courts consider ratings to be a demonstration of due diligence or lack thereof (see above 7.3. Recognition of

[174] Similarly in the case of auditing companies, C.J.H. Jansen and A.J. van der Lely, "Haftung für Auskünfte; ein Vergleich zwischen englischem, deutschem und niederländischem Recht," *ZEuP* 1999, 229-245 (235).

rating agencies under German law). The administrative branch also requires the observation of ratings. *BAFin* and the BVA have formulated guidelines for insurance companies/social security agents to invest bound capital only in investment grade rated securities; exceptions have to be justified.[175] A downrating can, therefore, lead to chain-reactions by insurance firms.[176]

[175] "Schreiben des Bundesversicherungsamtes," *Geschäftszeichen* V 1 – 4060 – 2101/99, 1. December 2000, December 1, 2000, 3; *Schreiben des Bundesversicherungsamtes*, *Geschäftszeichen* V 1 – 411 – 4381/2003, 1. December 2004, September 10, 2004, 3. *Bundesanstalt für Finanzdienstleistungsaufsicht (BAFin), Rundschreiben* 29/2002 (Versicherungsaufsicht) from December 12, 2002, Teil A: "Hinweise zur Anlage des gebundenen Vermögens von Versicherungsunternehmen" (§ 54 Abs. 1 VAG, §§ 1 ff. AnlV), Nr. I, 1, c), http://www.*BAFin*.de/cgi-bin/*BAFin*.pl?verz=0605040000&sprache=0&filter=v&ntick=0

[176] Eberhard Vetter, "Rechtsprobleme des externen Ratings," Wertpapiermitteilungen (WM), 2004, 1701 (1702).

8. Criteria for the Wrongfulness of a Rating

As far as ratings imply a factual assertion as to the issuer in exceptional cases, or imply a factual assertion on the due diligence process of the rating agency itself, it is conceptually rather easy to examine the wrongfulness of a rating as a factual statement. Nevertheless, as far as a rating does not make such implication and is a professional inference from external data and information, the assessment of whether the rating agency has committed any errors in its findings becomes more intricate. However, if a rating does not make such implications or inferences from external data, it becomes more difficult to asses any mistakes the rating agency may have committed in its findings. The following points only concern criteria that might be decisive when considering the correctness of ratings as expressions of opinion, not as statements of fact.

8.1. Inaptitude of economic indicia as decisive criteria

As Claire Hill points out, it is easy to "second-guess" a rating.[177] Ratings are prospective *ex ante* statements of opinions on the probability of default in the future.[178] S&P defines its ratings with the following:

> "A Standard & Poor's issue credit rating is a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific

[177] Claire Hill, "Regulating the Rating Agencies," presented at the American Law & Economics Association Annual Meeting, 2004, Paper 1, *Georgetown University Law Center, Business, Economics and Regulatory Policy, Working Paper*, no. 452022, 62.
[178] Cf. Paul Maynard, Managing Director - UK Portfolio Management Board, Corporate Division, AON, 1.

> financial program (including rating on medium term note programs and commercial paper programs). It takes into consideration the creditworthiness of garantors, insuerers, or other forms of credit enhancement on the obligation and takes into account the currency in which the obligation is denominated.[179] The issue credit rating is not a recommendation to purchase, sell, or hold a financial obligation, in as much as it does not comment as to market price or suitability for a particular investor.
> Issue credit ratings are based on current information furnished by the obligors or obtained by Standard & Poor's from other sources it considers reliable. Standard & Poor's does not perform an audit in connection with any credit rating and may, on occasion, rely on unaudited financial information..."

As the above quotation makes clear, ratings are mainly based on information provided by the obligor. If – as was the case with Enron or WorldCom – the managers of the issuer are trying to defraud the investors, the rating agency's rating will surely be wrong, but that error can not be imputed to the rating agency.

Ratings can also function as self-fulfilling prophecies. The assumption that a rating is (unduly) "positive" might be enough to alleviate the financing problems of the issuer and lead him to new growth. Conversely, the assumption that a rating is (unduly) "negative" might result in the equivalent of a bank-run with liquidity suddenly drying out.[180]

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[179] Typically, due to the control of a currency by national sovereigns, the risk associated with a local currency bond of such a sovereign is lower than the risk associated with an issuance in a foreign currency. Cf. Roman Kräussl, "Sovereign Risk, Credit Ratings and the recent financial crises in Emerging Markets, Empirical Analysis and Policy Implications," *Schriftenreihe des Center for Financial Studies an der Johann Wolfgange Goethe-Universität Frankfurt am Main*, *Monographien XVIII,* Frankfurt am Main 2003, 24.

[180] Roman Kräussl, "Sovereign Risk, Credit Ratings and the Recent Financial Crises in Emerging Markets, Empirical Analysis and Policy Implications," *Schriftenreihe des Center for Financial Studies an der Johann Wolfgange Goethe-Universität Frankfurt am Main*, *Monographien XVIII*, Frankfurt am Main 2003, 41.

In this respect, there is no simple criterion which would indicate the wrongfulness of a rating. In his empirical study on the performance of sovereign credit ratings, Kräussl cites the following criteria with which to "investigate the performance of [sovereign] credit ratings:"

1. Durability,
2. Reliability,
3. Market comparison.

Yet none of these factors are later found to be decisive by Kräussl. He correctly points out:[181]

> "But as it is true of all statements about risk, credit ratings cannot be proved right or wrong simply by the occurrence or non-occurrence of the event upon whose risk they state. Griep and de Stefano[182] note in this context that the default on a government bond rated AAA upon issuance does not prove that the original sovereign rating was incorrect (too high), any more than the punctual payment of a government bond initially rated CCC proves that the sovereign risk assessment was incorrect (too low)."

On the question of market comparison, Kräussl empirically tests yield spreads. His findings are once again – not surprisingly – inconclusive. He finds that the Asian crisis of 1997-1998 came as a complete surprise to the business community. In this case, both rating agencies and market participants "got it wrong." Assume for instance, that the rating agencies had not foreseen the crisis

[181] Roman Kräussl, "Sovereign Risk, Credit Ratings and the Recent Financial Crises in Emerging Markets, Empirical Analysis and Policy Implications," *Schriftenreihe des Center for Financial Studies an der Johann Wolfgange Goethe-Universität Frankfurt am Main*, *Monographien XVIII*, Frankfurt am Main 2003, 81.

[182] Griep, C. and M. de Stefano (2001): "Standard & Poor's Official Response to the Basel Committee's Proposal," *Journal of Banking & Finance* 25 (1), 149-169.

but the business community had indeed correctly predicted its occurrence; would that be conclusive evidence?

Furthermore, if courts would base their analysis of ratings solely on their durability, they might place the wrong incentives on rating agencies to cover up prior misperceptions. Overall, ratings have proven to be stable enough for the market to give them deference, but flexible enough to consider changes in credit quality. S&P, for example, provides the following statistic for rating durability:

Figure 16: S&P Average Multi-Year Transition Matrices, 1981 to 2004

S&P Average Multi-Year Transition Matrices, 1981 to 2004 (continued) (%)

	10-Year Transition Rates								
From/To	AAA	AA	A	BBB	BB	B	CCC/C	D	N.R.
AAA	30.18	24.02	9.69	3.76	0.14	0.00	0.00	0.56	31.64
AA	1.74	29.45	28.11	6.89	1.02	0.38	0.02	0.88	31.53
A	0.33	5.97	35.97	15.98	3.37	1.20	0.07	1.92	35.19
BBB	0.22	1.63	13.36	28.29	7.01	1.82	0.22	5.27	42.19
BB	0.10	0.13	3.01	13.48	10.11	4.87	0.52	17.68	50.09
B	0.00	0.07	0.93	4.38	6.70	6.14	0.71	29.17	51.91
CCC/C	0.20	0.00	0.41	0.82	3.47	2.45	0.41	50.20	42.04
	15-Year Transition Rates								
From/To	AAA	AA	A	BBB	BB	B	CCC/C	D	N.R.
AAA	17.01	21.18	14.47	2.62	0.33	0.41	0.00	0.98	43.01
AA	1.81	17.68	26.93	8.90	1.18	0.53	0.00	1.74	41.22
A	0.45	4.22	26.65	15.89	4.03	1.13	0.08	3.21	44.34
BBB	0.16	1.41	11.26	20.51	5.07	1.86	0.19	8.41	51.12
BB	0.09	0.26	3.08	9.04	5.65	2.35	0.26	23.50	55.78
B	0.00	0.00	1.10	4.15	3.27	2.78	0.65	35.50	52.55
CCC/C	0.34	0.00	1.37	1.37	3.78	1.37	0.00	53.95	37.80
	20-Year Transition Rates								
From/To	AAA	AA	A	BBB	BB	B	CCC/C	D	N.R.
AAA	6.71	14.00	18.74	4.93	0.20	0.59	0.00	1.18	53.65
AA	1.58	8.13	21.67	13.77	1.88	0.23	0.08	3.39	49.29
A	0.54	2.31	20.80	14.21	3.62	1.89	0.25	5.72	50.66
BBB	0.14	1.15	8.26	17.67	3.59	1.15	0.54	11.04	56.47
BB	0.00	0.21	2.11	5.28	3.38	2.85	0.21	30.10	55.86
B	0.00	0.00	0.38	2.30	2.43	1.28	0.26	36.49	56.85
CCC/C	0.00	0.00	0.00	0.00	7.14	0.00	0.00	44.29	48.57

Source: Standard & Poor's Global Fixed Income Research; Standard & Poor's CreditPro® 7.0.

The table shows the relative tendency of ratings to linger at their previous levels; at the same time, within a time frame of 20 years, the probability of an original AAA-rated issuer to remain at AAA was only 6.81%.

Ratings, like the market pricing of bonds (the yield is an expression of the risk appraisal inherent in a bond issuance), are but one way to predict future events. Nevertheless, both can be "misleading." Conversely, had rating agencies predicted the Asian crisis, its actual occurrence could possibly be explained

as having been caused by the rating agencies themselves. Hence, there is no conclusive test for determining whether a rating *ex ante* was misleading or not.

Should the law capitulate on this point and therefore implicitly declare that rating agencies are not bound by the law? This would seem to be neither reasonable nor desirable. In the case of evidence of intentional collusion between the rating agency and the issuer, no judge – be it in the US, in Germany or elsewhere – would hesitate to find the rating agency liable for the damages incurred by the investors relying on, or presumed to be relying on that particular rating. The theory of liability in that case seems to be a somewhat secondary question.

8.2. Limited judicial control as a solution

The case of negligence is more difficult than that of intent. How would the judge in such as case qualify a rating as wrongful? Generally, a rating agency is in a much better position to scrutinize an issuer than a judge is. A judge does not have the economic know-how and experience to pass judgment on the relative (mis)performance of a rating agency. He could, however, as in other cases requiring particular know-how (imagine for example litigation arising out of construction issues), hear expert testimony on the issue.

German doctrine faced with a similar dilemma in administrative law has developed a solution. In German administrative law, it is recognized that the judiciary has, in exceptional cases, is only allowed a limited review to control the public administration. This theory of judicial restraint applies notably in cases where judicial control would hamper the ability of the executive to exercise economic oversight. The list of limited judicial control established by the administrative courts is exclusive:

1. Judicial control of examinations,
2. Judicial control of school decisions having the character of appraisals (deferrals, assignments to specialized schools, etc.),
3. Judicial control of performance reports for public office servants,
4. Judicial control of decisions having appraising character through independent bodies of experts (for example, the admission to trading by an exchange, the classification of films as dangerous for the young by an independent agency for the control of films),
5. Judicial control of prognostic decisions and risk assessments, in particular in the area of environmental law and public business law.

In such cases, control is limited.[183] Case law is most specific on the judicial control of oral examinations. In a decision by the highest administrative court (Bundesverwaltungsgericht) of April 4 1959,[184] the court argued that examinations cannot be repeated under identical conditions and that the courts could not appraise the administrative decision for lack of comparability with other cases. The judicial control of administrative decisions could, therefore, only be limited to verify whether:

1. the administrative rules on procedure had been observed,
2. the examiners had correctly appraised the facts,
3. the generally recognized principles of appraisal had been observed, and
4. the examiners have not been guided by unreasonable purposes.[185]

[183] The following is explained well by Hartmut Maurer, "Allgemeines Verwaltungsrecht," 12. edition, § 7 Ermessen und unbestimmter Rechtsbegriff, 137-141.
[184] Decision as of 24.4.1959, BVerwGE (official gazette), 8, 272 (7 C 104.58).
[185] In a more recent case of 17.4.1991 the German Constitutional Court (Bundesverfassungsgericht) required the administrative courts to enlarge their control in order to obey to the principle of full judicial control as required by Art. 19 para. IV of the

In a later decision, the German Constitutional Court explained the rationale governing this limited control (translated[186]):

> "Examiners have to proceed on the assumption of appraisals and experiences which they have developed in the course of their examination practice for similar examinations and which apply generally. The definitions of grades according to the grading scale requires this even explicitly as far as it refers to an average performance. But even the threshold to passing, that is to say the scale for insufficient performances, may not be defined in a fixed manner and without regard to the average performance… Therefore, examination grades may not be seen in an isolated fashion, but they are contained in a system of relations which is influenced by the personal experiences and opinions of the examiners. Because the complex considerations which underlie the grading of an examination, may, on the other hand, not be described rigidly, the judicial control would thus lead to a distortion of scales. In the administrative process of each candidate the court – even with the help of expert testimony – was not able to discover the appraisal criteria which were relevant for the entirety of comparable examinees in order to apply them to one individual examination situation which may be re-construed only in its outlines. The court would have to find its own criteria of appraisal and replace those of the examiners… The equal assessment of all comparable candidates may only be obtained if the agencies of examinations retain a latitude for judgment for examination-specific assessments and if the judicial control is reduced in this regard."

Similar criteria of restrictive judicial control have already been applied by the Federal Supreme Court (*BGH*) with respect to the liberty of expression

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constitution. The German Constitutional Court decided that one would have to differentiate between examination-specific appraisals to which judicial control was denied and control for scientific correctness to which judicial control would be required. BVerfGE 84, 34 [59] (1 BvR 419/81, 1 BvR 2/83, 1 BvR 3/83, 1 BvR 213/83*)*.

[186] Bundesverfassungsgericht, BVerfGE 84, 35 (51) (1 BvR 419/81, 1 BvR 2/83, 1 BvR 3/83, 1 BvR 213/83*)*.

under art. 5 GG and the criteria for liability of the Foundation for Consumer Product Tests ("Stiftung Warentest")[187]:

> "The thresholds for illicity [of opinions on product tests[188]] is only passed where a conscious defective assessment or a conscious misrepresentation is at stake, in particular through incorrect statement of facts or one-sided selection of the goods and services for the comparison, but additionally also in cases in which the procedure for assessment and the conclusions drawn from the performed tests do not seem to be objectively justifiable ("worthy of discussion") […]."[189]

The idea to transpose the criteria for consumer product tests to rating agencies' rating actions is not entirely new.[190] Nonetheless, the criteria developed in parallel cases by the administrative justices seem to be somewhat more precise than these rather generic pronouncements of the civil law judiciary. Thus, the view held here is that the control criteria established in administrative cases allowing for limited discretion of public authorities should be transferred to the private law assessment of the correctness of ratings. While the (civil law) product test-decision introduced the idea of judicial restraint in the private law

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[187] *BGH* NJW (comparative product test with requirements exceedings DIN-norms – Vergleichender Warentest mit über DIN-Normen hinausgehenden Anforderungen"), as of 10.3.1987, VI ZR 144/86, 1987, 2222 f.

[188] Paranthesis added.

[189] *BGH* NJW (comparative product test with requirements exceedings DIN-norms – "Vergleichender Warentest mit über DIN-Normen hinausgehenden Anforderungen"), as of March 3, 1987, *VI ZR* 144/86, 1987, 2223: "Die Grenze der Unzulässigkeit ist dann erst überschritten, wo es sich um bewußte Fehlurteile und bewußte Verzerrungen, insbesondere auch unrichtige Angaben und einseitige Auswahl der zum Vergleich gestellten Waren und Leistungen handelt, aber auch dort, wo die Art des Vorgehens bei der Prüfung und die sich aus den durchgeführten Untersuchungen gezogenen Schlüsse als sachlich nicht mehr vertretbar ("diskutabel") erscheinen, (vgl. Senat, BGHZ 65, 325 [334 f.] = NJW 1976, 620 = LM § 824 *BGB* Nr. 20)."

[190] For ex. Johannes Fiala and Christian Kohrs, "Verantwortlichkiet und Haftung einer Ratinggesellschaft gegenüber Dritten am Beispiel des Versicherungsratings," in: *Rechtsfragen im Rating, Grundlagen und Implikationen von Ratings für Agenturen, Investoren und geratete Unternehmen*, eds. Ann-Kristin Achtleitner and Oliver Everling, (Wiesbaden: Gabler Verlag 2005), 341-355, 353.

field, the transfer of more precise criteria of judicial restraint of the public law field to the domain of rating agencies would still represent progress in the current state of the law. The theory of judicial restraint to assess the correctness or defectiveness of ratings is equally fitting in Common Law as in Civil Law jurisdictions.

Although in general, administrative law and business law are governed by different principles, here might be one area where these rules of limited judicial control are easily transferable. The examination of candidates and the appraisal of enterprises for creditworthiness are not as different from one another than might appear at first glance.

Given the public benefit and positive externality that rating agencies provide to the capital markets, it is theoretically quite conceivable that countries would establish a rating agency as an administrative body whose appraisal opinion would be required prior to each issue of securities. Like the financial supervisory authorities, it would also be conceivable that such an agency fund itself through contributions of the issuers.

In this case, under German law these principles of limited review would have to be applied. Would it make any difference for the analysis if such a body were to evolve in the private sector? Probably not. There are, in fact, cases in which private self-regulation has been replaced by administrative control. This is notably what occurred with the implementation of the prospectus directive. The German stock exchange used to control the admission of new securities to trading ("private" self-regulation), but control has now been transferred to the German supervisory authority.

The appraisal situation of a rating procedure is quite similar to that otherwise described by the administrative courts as justifying limited control: A collegial body of experts makes a decision of prognostic character. The ap-

praisal depends on comparability to similar decisions and cannot be repeated under identical conditions. Last but not least, it must be said that the courts are not the best equipped to scrutinize such decisions because the proceedings require specific know-how and expertise. Under such circumstances administrative courts do in fact already exercise limited control and the similarity of the situation to the rating procedure warrants transferring the administrative solution to the rating procedure.

Whilst not following quite the same train of thought (but drawing from a case involving *Stiftung Warentest* in which similar standards were applied), Habersack has proposed similar standards for judicial control, namely, the restriction of such control to inadequate procedure (loss-causation will be a problem accordingly) and inadequate basis of information or disregard of facts.[191] He concludes his analysis by arguing in favor of a duty of continued supervision on the basis of prior creation of risk. [192]

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[191] Cf. Matthias Habersack, "Rechtsfragen des Emittenten-Ratings," *ZHR* 169, 2005, 185-211 [191]

[192] If such duty is upheld, one should, however, bear in mind that the market expects stability of ratings; thus, the expectation of stable ratings leads rating agencies to a certain inertia when otherwise rating adjustments might need to be made. As Löffler puts it: "Rating bounce avoidance is thus an important candidate for explaining the stylized facts of agency ratings. Another candidate is informational inefficiency. If rating agencies are slow to react to new information, stability will increase, and rating changes will become predictable. Differentiating between these alternative explanations is difficult. The analysis has shown, however, that rating bounce avoidance can reduce the informational content of ratings by more than a rating system which reviews credit quality only twice per year. In addition, infrequent reviews cannot explain the observed dependence of rating changes." Gunter Löffler, "Avoiding the Rating Bounce: Why rating agencies are slow to react to new information," 97, June 2002, ISSN 1434-3401, Chair of Banking and Finance, Goethe-Universität Frankfurt, 14.
Given this inherent dilemma, rating agencies should simply be bound to announce when the last rating was assigned and when the next rating review will take place at the latest in order to increase the informational value of each rating assigned.

Consequently, ratings can only be found to be "wrongful" if:

1. a prescribed or otherwise necessary procedure is not followed
2. the rating agents could not assume the facts underlying their rating from the material that is freely accessible and submitted by the issuer,
3. the rating agents have not observed generally recognized criteria of appraisal,
4. The rating agencies abused their discretion

Relating to condition 1 above:

So far, there is no legally prescribed procedure for the rating agencies to follow when establishing a rating? One requirement for such a procedure would, for example, be that the rating agency in question would have to constitute a body of appraisal with at least two or three members. It seems evident that the limited review is warranted only in cases in which the decision-taking process is "quasi-legal." One can imagine situations in which the actual discussion among the rating agents called for no more than five minutes and preparation for the discussion was accordingly deficient. On the other hand, a prior presentation to the management team by the issuer should not be regarded as an undue indicator of collaboration, nor should the absence of such a meeting be seen as an indication of insufficient review.

If the various governments and supervisory agencies cannot produce minimum criteria of procedure, the decision as to which minimum criteria of procedure have to be followed should be left up to the courts.

Relating to condition 2 above:

Rating agencies have no obligation to verify the information submitted by the issuer. However, they cannot, without some minimum form of control,

assume the plausibility of any information to which there is free access. Imagine the case of press rumors stating that a company has payment difficulties. On the one hand, the rating agency has a duty to notify the investors without undue delay of up-coming difficulties; on the other hand, a rating agency may not rely on just one media source alone. Testing the correctness of the factual assumptions can only be based on their plausibility. If a more serious media source has reported on the matter, at a certain point in time the plausibility test tilts in favor of requiring the rating agency to adjust its rating within some reasonable delay.

Relating to condition 3 above:

Of course, these generally accepted criteria for appraisal are not easy to identify.

Imagine, for example, an industrial issuer that builds power plants. If such an issuer was in the process of negotiating a new contract for construction with a foreign government and ultimately lost that contract to a competitor, generally this would be appraised negatively by the rating agency. If the rating agency awards a positive rating despite the negative outcome of negotiations, it would appear that the generally accepted criteria for appraisal have not been adhered to. Of course, even unsuccessful negotiations can be an indicator of further growth, for example, for a start-up company hoping to acquire its first client, but according to the abovementioned points, a positive rating would require further justification.

Relating to condition 4 above:

Abuse of discretionary power would apply if the rating agency were to try to collude with the issuer in order to grant an unduly beneficial rating. Misguidance might also be an applicable fact pattern if the rating agency compels

an issuer to ask for a rating by assigning an unduly negative rating. This criterion of control asks for the motives behind an appraisal decision.

Generally, it may be presumed that the rating agency's motive is to inform the capital markets correctly. There might, however, also be cases in which an abuse of power is taking place, although such would be very difficult to prove in a court of justice.

Assuming a suitor can prove a rating to be implausible, he or she would still have to prove damages resulting from that fault. Causality is a tricky issue in the rating business. The simple downgrading of a bond alone might cause sell-offs by lenders in that particular risk, further exacerbating the problem and driving the rated issuer into bankruptcy. The reverse is true with regard to rating enhancements. A rating of AAA is certainly an asset that will enable the issuer to find refinancing more easily. It is clear in this light that ratings can be self-fulfilling. As a result, causality may only be proven if the ratings imply an implausibly [positive] credit risk while in reality a much lower rating would have been appropriate.

9. Recommendations for Regulatory Supervision

The influence of rating agencies as largely unregulated but nevertheless (through NRSRO registration) protected private entities guarding the entrance to the "economic highway" leaves many observers uneasy about the lack of regulatory oversight. Although NRSROs are required to register as investment advisers under the Investment Advisers Act of 1940, the "investment adviser registration system applies awkwardly at best."[193] The new NRSRO registration system under the Rating Agency Reform Act of 2006[194] may lead to the amelioration of the current lack of regulation. However, the issue of liability is left unclear by the Rating Agency Reform Act and will thus remain to be decided according to general common law. In the US the majority opinion would probably require a recklessness standard to be breached prior to finding a rating agency liable. In the UK, there are both cases which could be raised both in favor and against a liability of rating agency for negligence. Only under German law, negligence would at least conceptually be sufficient to find a rating agency liable.

Given the universal nature of ratings and the international nature of bond issuances, it does not make sense, however, to establish differing standards of care for each jurisdiction. The IOSCO Code of Conduct also exemplifies the common understanding for the need of a universal standard of care.

The view held here, is that conceptually negligence should be sufficient to render a rating agency liable, but that the courts are only allowed limited review to find a rating incorrect. That may come close to the recklessness standard of care but is still different. Where for example not the discretion inherent

[193] Andrew Fight, *The ratings game*, (New York: John Wiley & Sons, 2001), 155-171.
[194] Attached as Appendix 2.

at a rating decision as such is at stake (imagine e.g. a rating agency mis-spelling its rating "A"for "B" or incorrectly summing up the components leading to a rating score), the rating agency's liability could be proven under this proposed standard (legal review would be allowed in so far), but would not be sufficient under a recklessness standard. To dissipate the standard of care with the judicial review authority effectively leads to questioning where precisely the rating agency "got it wrong" instead of a rather abstract debate on whether or not negligence is sufficient to merit an action. This view is new to this field and has been only alluded to by certain German authors[195]. In the US, generally, negligence is probably not considered sufficient to find a rating agency liable.[196]

When calling for further governmental influence one must also remember that political pressure would be exercised by the business world as well. Traditionally, government ratings have served as "ceilings" to the rating of commercial businesses. If, for example, country X received a rating of B+, no individual business according to the "government ceiling-theory" may top that rating.[197] The ceiling rule is biased in favor of the US government.

> "Any security issued **directly** by the U.S. government is considered free of default risk. Although these bonds are not rated, they are considered the safest and highest-quality securities that you can buy because a default by the U.S. government is deemed impossible. This includes all Treasury securities, as well as savings bonds."[198]

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[195] Cf. Matthias Habersack, "Rechtsfragen des Emittenten-Ratings," *ZHR* 169, 2005, 185-211 [191].
[196] Huisian, Gregory, "What standard of care should govern the world's shortest editorials?: An analysis of bond rating agency liability," 75 *Cornell L. Rev.* 410 (1989-1990), pages 411-461.
[197] Däubler, Wolfgang, "Wer kontrolliert die Rating-Agenturen," *NJW* 2003, 1096 (1097).
[198] Annette Thau, *The bond book, everything investors need to know about bonds*, 2nd edition, (New York: McGraw Hill 2001), 37.

There is no economic reason supporting such a U.S. sovereign exemption. Conceptually, U.S. may as well as other governments default on its liability. Particularly at a time when the US government finances are increasingly provided by foreign (mostly Asian) investors and governments, the fate of the U.S.'s creditworthiness is tied to the strength of the dollar.

It seems, however, that with the downgrading of Japanese government bonds the sovereign ceiling rule has been adapted. Certain Japanese companies, especially in the export-driven high-tech segment, should, in this respect, still be able to achieve AAA status even though many of them were downgraded when Japan's long-term foreign currency rating was downgraded from Aaa to Aa1 by Moody's on November 18, 1998.[199] Kräussl reports Moody's and S&P as having abandoned the "sovereign ceiling" rule.[200] However, particularly in regards to developing countries, we can safely assume (most likely as a rule of thumb) that government ratings are equivalent to a "ceiling." The International Monetary Fund has observed that, owing to the potential threat of capital seizure by bankrupt sovereigns, structured products usually provide offshore collateral arrangements under which funds would never have to enter the country in which the business is domiciled and are therefore protected from sovereign seizure.

Under such circumstances it is highly doubtful that the benefits of further regulation (apart from NRSRO status registration) would outweigh the aforementioned concerns.

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[199] Roman Kräussl, "Sovereign Risk, Credit Ratings and the recent financial crises in Emerging Markets, Empirical Analysis and Policy Implications," *Schriftenreihe des Center for Financial Studies an der Johann Wolfgange Goethe-Universität Frankfurt am Main*, *Monographien XVIII*, 2003, 32.

[200] Roman Kräussl, "Sovereign Risk, Credit Ratings and the recent financial crises in Emerging Markets, Empirical Analysis and Policy Implications," *Schriftenreihe des Center for Financial Studies an der Johann Wolfgange Goethe-Universität Frankfurt am Main*, *Monographien XVIII,* 2003, 32.

Furthermore, research also suggests that, in general, the oligopolistic market functions to the advantage of the investor. Of course, a few shocking examples such as Enron and the Asian crisis seem to suggest otherwise at first glance. But statistically there are few such exceptions. The market for ratings has all the characteristics of a natural oligopoly. If there were only one player in such a market, market pressure would be insufficient to uphold satisfactory rating quality. However, if the number of players were unlimited, the individual rating would find no market acceptance and thus be worthless. Also, if the number of players were unlimited, the individual rating agency would have too strong an incentive to yield to pressure from an individual issuer. In addition, research capabilities and comparability of ratings can only be achieved if the rating agency is as much a global player as the issuers whose credit risk it evaluates. Moody's itself has offered one more practical reason as to why the market for ratings is so concentrated:

> "… Management-time is costly – issuers of bonds only ask for few ratings because the fundamental credit analysis, and therefore the entertainment of a rating relationship, requires a substantial amount of time expenditure and engagement from the part of the issuer's management."[201]

At least under German law some residual likelihood of liability persists that should suffice to enhance the scrutiny and reliability of ratings.[202] The rating agency – given the potential for future dispute – will have some incentive to document its decision-making process. This would be a desirable side effect of

[201] Detlef Scholz, Moody's Deutschland GmbH, "Stellungnahme von Moody's anlässlich der Anhörung vor dem Finanzausschuss des Deutschen Bundestages zum Thema 'Ratingagenturen,'" presented by Detlef Scholz representing Moody's Investors Service, 3. March 2004, 8.

[202] For the opposing view, Däubler, Wolfgang, "Wer kontrolliert die Rating-Agenturen," *NJW* 2003, 1096 (1097) who finds that the "absolutism" of rating agencies is undeserved.

the threat of litigation because it provides rating agencies with the incentive to follow sound principles of judgment and procedure.

9.1. Limited judicial control

It might be desirable for US courts as well to follow the route of limited control as indicated in chapter 7. The criteria for limited judicial control are not as foreign to the US judicial system as might appear at first glance. With regard to rule 10b-5, the courts have, for example, allowed liability for wrongful prognostic "statements," but at the same time have also stipulated certain exemptions. These include:[203]

1. an exemption for forward-looking statements (Rule 175 to the Securities Act and Rule 3b-6 to the Securities and Exchange Act), unless the prognosis was not based on a plausible cause or was not been published in good faith.
2. an exemption for prognostic statements which deems them to be non-material if they were accompanied by concrete warning signs ("bespeaks caution doctrine").[204]

The degree of judicial scrutiny proposed here would function as similar plausibility control. Limited control is the key to a correct delimitation of competences and liabilities. The criteria for the limited judicial control of administrative decisions should be transferred to the control of rating actions. The control of rating actions should be limited to the following four-prong test:

[203] For information on the applicability of these exemptions and the detailed case-law, please consult Knut Sauer, "Haftung für Falschinformation des Sekundärmarktes," (PhD diss, Frankfurt 2004), 105 et seq.
[204] The "bespeaks caution doctrine" has been codified by the Private Securities Litigation Reform Act in 1995.

1. Is a prescribed or otherwise necessary procedure not followed (procedural conduct)?
2. Was the assumption of facts by the rating agents plausible according to the freely accessible material and submitted by the issuer (factual plausibility)?
3. Have the rating agents observed generally accepted criteria of appraisals (plausibility control of criteria), and
4. Were the rating agents misguided by alien purposes (motive control)?

9.2. Limited administrative control

It remains heavily disputed whether or not the procedures of rating agencies should be subject to greater administrative control. The European Banking Federation (representing 4,000 banks) has for example rejected a European Parliament report calling for tighter regulation of rating agencies.

Increased government intervention could compromise the political and economic independence of rating agencies. In many countries, the government would be tempted to use its influence to force rating agencies into issuing benevolent ratings on the government's own securities as well as on state-owned enterprises or other principal businesses. This is particularly true for government ratings of highly indebted countries where the incentives to pressure the rating agencies are strongest.

The view held here is that some well-balanced administrative surveillance is warranted and should not lead to a political control of rating agencies. With respect to administrative control, the issue is really, to strike the right bal-

ance. This differs from the probably more disputed area of judicial liability where the question if judicial control should at all play a role is as disputed as the degree of control for the proponents arguing in its favor. Judicial and administrative control may, however, also show similarities. Many of the conduct requirements proposed in further detail below stem from the rules applicable to judicial proceedings. This is by no means a coincidence. Although the procedural rules applicable to judicial proceedings seem rather specific, the procedural means for achieving quality and reliability are inherent to all rational decision-making processes. Thus, the sound principles of procedure prescribed to judicial procedures are not, by their nature, limited to the legal profession. The following criteria for the adoption of sound procedures by rating agencies draw heavily from the principles prescribed for judicial procedures.

9.2.1. Procedural requirements to assure independence

In particular, such regulation should mandate rating agencies not to issue an unsolicited rating unless this is accompanied by a clear indication that the rating was issued solely on the basis of information that is publicly available and was not specifically requested by the issuer. To this end, it is not sufficient to simply provide the reference "PI" (public information) as S&P have done in the past, since the key point is to abolish any incentive to exert anticompetitive pressure on issuers, and "PI" is simply too confusing an abbreviation to indicate clearly enough to the markets that the issuer did not solicit this rating. Nor does the approach taken by Moody's (which hardly assigns any unsolicited ratings

any more[205]) completely remedy the situation with its more explicit method of announcing that a rating is unsolicited as in the following press release:

> "This rating has been initiated by Moody's. The issuer has not solicited the procedure of rating assignment."

A statement of this nature still constitutes an abbreviation because it does not disclose (unless the reader has in-depth knowledge of the issue) that Moody's initially "invited" the issuer to solicit a rating procedure, or that such an "invitation" was declined. A disclosure for unsolicited ratings should fully alert the general public of the potential conflict of interest[206] inherent in unsolicited ratings and should be identical for all rating agencies.

Even *de lege lata*, one may argue that competition law may dictate to the rating agency a requirement to disclose whether a rating has been assigned as the result of a fee arrangement ("solicitation") since ratings may otherwise appear to be entirely impartial scientific appraisals while in reality being part of the usual marketing procedure for securities.[207]

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[205] "… For instance, following conversations with various business and market leaders and other market participants, we amended our approach to so-called "unsolicited ratings" in 2000, specifying the future conditions under which such ratings, if any, would be assigned and published, and effectively ending the practice in Europe." Raymond McDaniel, President, Moody's Investors Service, "The Role and Function of Rating Agencies: Evolving Perceptions and the Implications for Regulatory Oversight," report based on a speech presented to the Association of French Treasurers (AFTE) on February 5 in Paris, France, 2.

[206] Matthias Habersack, however, thinks that unsolicited ratings would not be subject to a conflict of interest; on the other hand, it may be argued that rating agencies might vent their "wrath" on the issuer should the issuer refuse the "invitation" to request a (costly) rating service, Matthias Habersack, "Rechtsfragen des Emittenten-Ratings," *ZHR* 169 (2005), 185-211

[207] Cf. Johannes Fiala and Christian Kohrs arguing on grounds of section 4 nr. 3 UWG, "Verantwortlichkeit und Haftung einer Ratinggesellschaft gegenüber Dritten am Beispiel des Versicherungsratings," in: *Rechtsfragen im Rating, Grundlagen und Implikationen von Ratings für Agenturen, Investoren und geratete Unternehmen*, eds. Ann-Kristin Achtleitner and Oliver Everling, (Wiesbaden: Gabler Verlag 2005), 341-355, 353.

Fee arrangements should not place the wrong incentives on either the issuer or the rating agency. Moreover, the fee structure should be transparent and identical for all issuers and not be subject to negotiations.[208] In addition, the fee should be set at the beginning of the rating process and be paid in advance. If the fee and the rating action become economically interrelated, which they legally are (one obligation being the consideration of the other), the independence of the rating agency is at stake.

The policies of rating agencies, which are available to the public, should make it a precondition for each member in the rating agencies' team of analysts' to be free of any personal bias or situation which could give rise to the suspicion of bias towards an issuer.

Like investment banks (which sell securities to the public while advising the issuer at the same time), rating agencies have also recently become prone to conflicts of information. This situation is revealed quite clearly by the following demand made by the Investment Company Institute (i.e. the national association of the American investment company industry - ICI): [209]

[208] "Moody's disposes of fixed fee principles for bond issuances; negotiations on fees are avoided wherever possible." Detlef Scholz, Moody's Deutschland GmbH, "Stellungnahme von Moody's anlässlich der Anhörung vor dem Finanzausschuss des Deutschen Bundestages zum Thema 'Ratingagenturen,'" presented by Detlef Scholz representing Moody's Investors Service, 3. March 2004, 9.

[209] ICI Letter, Re: Proposed Definition of Nationally Recognised Statistical Rating Organisation (File No: S7-33-97), to Mr. Jonathan G. Kath, Secretary, Securities and Exchange Commission, as of March 1998, signed by Craig S. Tyle General Counsel of ICI, printed in Andrew Fight, *The ratings game*, (New York: John Wiley & Sons, 2001), 228-234 (232).

> "In particular, given that some NRSROs are now also recommending securities to clients (including the same securities which are rated by the NRSRO), it is critical that NRSROs have internal procedures designed to prevent the misuse of confidential information obtained through the rating process. For example, NRSROs should have in place ethical walls and other internal control procedures to prevent information divulged by a rated issuer from being used in recommending that issuer's securities."

The ICI also expressed its views in favor of "The Credit Rating Duopoly Relief Act of 2005"; it is thus likely that this bill will become law (proposed effective date is January 1st 2007:[210]

> "The Institute strongly supports the goals of H.R. 2990. The increased competition that the bill should facilitate, combined with appropriate SEC oversight, greater transparency to investors, and NRSRO accountability, would benefit mutual funds and other investors and help secure reliable and credible ratings."

As in the case of accounting firms, ancillary services should be restricted and other ties with rating agencies with the financial industry, which might impede their independence, should be severed. For example, McGraw-Hill, the publishing company and owner of S&P, also assigns security identification numbers.[211]

At least for government recognized rating agencies, limits should be set concerning the types of activities rating agencies may be permitted to conduct. It might seem self-explanatory, but it should still be prescribed by law that ratings may only be assigned by committees, not by individual analysts. In all ma-

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[210] Statement of Paul Schott Stevens, President Investment Company Institute on H.R. 2990, the Credit Rating Agency Duopoly Relief Act of 2005, Before the Committee on Financial Services United States House of Representatives, November 29, 2005. http://www.ici.org/statements/tmny/05_house_nrsro_tmny.html

[211] Matthias Habersack, "Rechtsfragen des Emittenten-Ratings," *ZHR* 169 (2005), 185-211 [196 et seq.].

jor judicial proceedings that decisions are made by collegial bodies. Similar criteria should be required of other quasi-judicial institutions – like rating agencies – that fulfill a public function.

9.2.2. Procedural requirements to assure quality and fair competition

Rating methodology, the business savoir faire which is at the core of the rating business and on which rating agency competition is based, should not be subjected to supervision. It is and it should be left to the market to decide which rating agency is most the competent in this issue.[212] However, there should be some minimum degree of control exercised with regard to the entry criteria.

Issuers should be allowed to present their views both during and after the rating process.[213] In this respect, it is certainly conceivable that issuers be allowed to add their opposing view to the rating report without infringing on the independence of the rating agency.

There are numerous ways to acquire the necessary know-how required for becoming a rating analyst, and the competency of a collegial body will ultimately depend on the mix of talents represented in such a pool. However, it is not apparent why an individual investment advisor must pass public examinations. A rating analyst, in contrast, is not subject to similar requirements even though his responsibility to the general public is much greater. Given that rat-

[212] Cf. Raymond McDaniel, President, Moody's Investors Service, "The Role and Function of Rating Agencies: Evolving Perceptions and the Implications for Regulatory Oversight," report based on a speech presented to the Association of French Treasurers (AFTE) February 5, in Paris, France, 4.
[213] Cf. Matthias Habersack, "Rechtsfragen des Emittenten-Ratings, " *ZHR* 169 (2005), 185-211 [198].

ings are assigned by teams, it may be assumed that the rating agency will try to achieve the greatest degree of competence within a team through diversity of experience. In order to best understand the financial data provided by the issuer, it might prove advantageous for one member, for example, to possess particular expertise in the industry to which the issuer belongs and another one to be a expert in accounting or mathematics etc. Therefore, given that no general criteria can be proposed with respect to minimum expertise or knowledge required, the benefits of entrance exams probably do not outweigh the disadvantages of bureaucratic intrusion inherent in government regulated exams. Alternatively, the task of conceiving and creating exams for their analysts could be left to the rating agencies themselves.

Rating agencies render a public service. By reducing information deficiencies, they add to the liquidity of the financial market place. While the "lemon market" theory of Akerlof is a widely accepted hypothesis, only recently has the effect of non-public (so-called "private") information been examined. Jonathan Levin has shown that private information reduces trade.[214] Using a simple theorem in which one side of the transaction has private information, he argues that "more information in the margin can only reduce trade." In fact, if it were to be imagined that one side of a transaction had better (including more accurate or up-to-date) information than the other, the asymmetry of information would, of course, reduce the willingness of the other side to participate in a transaction because the side with the more accurate and/or up-to-date information would have to assume that the deal was unfair. Due to the low volume of each individual transaction, private investors are crucial to the liquidity

[214] Jonathan Levin, "Information and the Market for Lemons," *RAND, Journal of Economics*, vol. 32, no. 4, Winter 2001, 657-666.

of a capital market. Their participation in the trading process, however, also creates externalities for institutional investors. If rating agencies could – for a fee – reserve their ratings as private information for institutional privileged investors only (for a given period, or with respect to some essential part of their opinion), the information externality would either be substantially reduced or even averted. To prevent this, rating agencies should be forced to publish the rating opinion itself (at the least) as soon as it is assigned.[215]

In a letter to the SEC relating the proposed definition of nationally recognized statistical rating organizations, The ICI also suggested limiting NRSRO recognition to rating agencies entering new markets to certain areas: [216]

> "Finally, the [SEC] Commission should authorize the Commission staff to grant limited-purpose NRSRO designation for rating agencies whose expertise and experience in rating securities is limited to certain types of securities. … By issuing limited purpose NRSRO designations, the Commission ensures that an NRSRO will not issue rating in securities that are outside of its knowledge and experience. For example, some ratings agencies may have expertise in rating the credit of US issuers, but do not have experience in rating securities by foreign corporations. Similarly, some rating agencies may be familiar with rating ordinary debt offerings but do not have significant experience in rating asset-backed securities. A limited purpose NRSRO designation would prevent such an NRSRO from issuing rating for which it is not qualified."

[215] Compare with the more lenient proposal of IOSCO, "Code of Conduct Fundamentals for Credit Rating Agencies," The Technical Committee of the International Organization of Securities Commissions, December 2004, http://www.iosco.org/.

[216] ICI Letter, Re: Proposed Definition of Nationally Recognised Statistical Rating Organisation (File No: S7-33-97), to Mr. Jonathan G. Kath, Secretary, Securities and Exchange Commission, as of March 1998, signed by Craig S. Tyle General Counsel of ICI, printed in Andrew Fight, *The ratings game*, (New York: John Wiley & Sons, 2001), 228-234 (233).

It would be best for the regulatory bodies not to extend the reliance on ratings any further. Nevertheless, *BAFin*, for example, has already misguidedly introduced a "shadow recognition procedure" for rating agencies to assess capital requirements for credit institutions.[217] The recognition criteria pertaining to NRSRO status are already somewhat unclear and Basel II has enhanced the importance of external ratings. Extending the use of NRSRO status to other fields would petrify the triopoly of Moody's, S&P and Fitch; if one believes in competition, then surely such extension would be undesirable. The ICI voiced concerns over the planned extension of NRSRO use to other fields in a letter to the SEC: [218]

> "The ICI strongly supports limiting the scope of the proposed amendments in this manner. Allowing NRSRO rating to be used for other purposes would be highly inappropriate. For instance, NASD Regulation, Inc. recently filed a proposal with the Commission to allow volatility rating in the mutual fund supplemental sales literature, so long as the volatility rating is issued by an NRSRO. Nevertheless, the expertise that NRSROs have in issuing credit ratings of debt securities is not at all indicative of their ability to predict the expected volatility of a bond mutual fund."

As to the formal type of regulation, Habersack[219] proposes following the IOSCO code of conduct and implementing a more precise version of these principles by EU law. Alternatively, he suggests imposing a registration obligation and making compliance to the code binding upon registration. Lastly, he sug-

[217] Bundesanstalt für Finanzdienstleistungsaufsicht, "Anerkennung von externen Ratingagenturen für Zwecke der Risikogewichtung im Rahmen der Solvabilitätsverordnung," BA 27 – GS 4036 – 2005/0001, 20 December 2005, 1. www.*BAFin*.de/schreiben/89_2005/051220_2htm.

[218] ICI Letter, Re: Proposed Definition of Nationally Recognised Statistical Rating Organisation (File No: S7-33-97), to Mr. Jonathan G. Kath, Secretary, Securities and Exchange Commission, as of March 1998, signed by Craig S. Tyle General Counsel of ICI, printed in Andrew Fight, *The ratings game,* (New York: John Wiley & Sons, 2001), 228-234 (233).

[219] Matthias Habersack, "Rechtsfragen des Emittenten-Ratings," *ZHR* 169 (2005), 185-211 [194].

gests establishing arbitration bodies in affiliation with each financial supervisory authority and allowing judicial proceedings to maintain their rulings. As has been proposed by the Credit Rating Agency Duopoly Relief Act, NRSRO approval should be replaced by mere registration. Also, anti-competitive practices should be forbidden, in particular "notching" and "tying." Notching is the practice of lowering the ratings on asset-backed securities unless a substantial portion of the assets making up those securities was also rated by the agency. Tying happens if agencies provide an unsolicited rating of a company along with a bill for the service implicitly forcing rated companies to purchase other services. The myriad of anti-competitive practices must, however, not be limited to the known cases of abuse. Rather, the SEC and the other national financial supervisors should have common criteria according to which abusive practices and competence to interfere can be determined. This area is, however, in all probability too specific to warrant competition control by agencies for competition control.[220]

[220] I. E. the Bundeskartellamt in Germany, the Competition Commission and the Office of Fair Trading in the UK, the Department of Justice and the Federal Trade Commission in the US.

10. Conclusion

Some form of implicit liability seems useful as a means of hindering the potential for abuse.[221] Rating agencies, especially less well-known institutions, might otherwise be tempted to provide inaccurate ratings, a result which could have disastrous consequences for investors and the general public. The costs of due diligence in the rating procedure are most efficiently absorbed by the rating agency itself rather than by investors, who rely on such data and have fewer means with which to protect themselves against rating deficiencies. Rating agencies are the "cheapest cost avoider." "Cheapest cost avoider" indicates which person in a production line would incur the least costs to avoid public damage. For example, in environmental cases, a factory would incur the least costs to avoid public damage (pollution); similarly, rating agencies would incur least costs to avoid the public damage (erroneous investments).

In simplified terms, it can be said that German law does not allow for a waiver of liability and will deem the contract between the issuer and the rating agency to be to the benefit of the investor. As a result, German law implies an objective standard of wrongfulness in the case of a solicited rating (negligence is presumed) and a standard of gross negligence (s. 826 *BGB*) in the case of an unsolicited rating.

American federal law exempts rating agencies from liability under the rule of prospectus liability. The views here considered suggest that the First Amendment will restrict rating agency responsibility to cases of malice, i.e. knowledge or reckless disregard for the truth. Unlike under German law,

[221] A similar position vis-à-vis accountancy firms is held by Wessel Heukamp, "Brauchen wir eine kapitalmarktrechtliche Dritthaftung von Wirtschaftsprüfern?," *ZHR* 169, 2005, 471-494 [485 and 490].

American courts will probably not argue on the grounds of third party beneficiary law, but will view the question of liability on the basis of tort principles. The extreme reticence of American courts might be explained by its dissimilar judicial methods. While litigants in German courts who lose a case have to bear the cost of litigation for their opponent, this "fee-shifting"[222] is (generally) not practiced in the US. Also, the possibility of punitive damages, of class actions, of witness testimony by parties[223] and the existence of a jury add to the "attractiveness" of US courts in the eyes of plaintiffs. Even actions with little chance of success pose a substantial threat to the defendant and might force such a defendant into accepting a settlement.[224] To counter check and balance this, the US courts have, therefore, developed other thresholds (pleading with particularity, extensive reading of the First Amendment, class action certification[225]) in order to limit access to the judicial system to justified cases only.

It is reasonable to predict that both the German and American courts will not easily allow rating agencies to be held liable, albeit to a lesser extent in the case of the former. Courts should be cautious when rendering rating agencies liable, given that liability granted too easily might lead to moral hazard for investors. In *Quinn v. McGrawHill*,[226] the sophistication of the investor and his insider knowledge were elements that clearly illustrated the tendency to some degree of recklessness by the investor when it came to relying on S&P's rating

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[222] On the effects of fee-shifting on securities class-actions, please refer to Theodore Eisenberg and Geoffrey Miller, "Attorney Fees in Class Action Settlements: An Empirical Study," *Journal of Empirical Legal Studies*, vol.1, March 2004, 27-78.

[223] Haimo Schack, *Einführung in das US-amerikanische Zivilprozeßrecht*, 2nd ed., (München 1995), VII, 64.

[224] Cf. Wessel Heukamp, "Brauchen wir eine kapitalmarktrechtliche Dritthaftung von Wirtschaftsprüfern?," *ZHR* 169 (2005), 471-494 [488].

[225] Geoffrey P. Miller, "Review of the Merits in Class Action Certification," *Law and Economics Research Paper Series,* New York University, Working Paper, no. 04-011, http://papers.ssrn.com/abstract=554663.

[226] Judgement of the Court of Appeals for the 7th Circuit, *Quinn v. McGraw-Hill*, 168 F.3d 331 (7th Cir. 1999).

despite superior insider information. It is likely that the number of competitors in this market will increase in the future; a certain degree of residual threat of potential liability should be welcomed.

American capital market law is, in most respects, more modern and has been influenced to a great extent by modern financial theory. Its complexity (state/federal law) renders its results, however, somewhat less predictable than the German code-based system.

For the UK, the finding is contradictory. On the one hand, there are quite a number of cases finding in favor of tort liability of expert appraisers; on the other hand, in cases mostly concerning auditors, the courts have been rather reticent to allow liability for mere negligence. The view held here is that the cases concerning auditors cannot be transferred to rating agencies ("distinguishing on the facts"), and that UK courts would allow recovery in cases of a concrete showing of mere negligence. With the provisions of the FSMA, the UK also possesses statutory capital markets law whose strict standards of care could possibly be applied also to rating agencies. The case law does not permit, however, to take this conclusion with certainty.

The German and the US legal system both show some similarities; for example, the fraud-on-the-market theory exists in the form of "investment mood" theory under German law.

Given the economically observable globalization of financial systems, US, UK and German law should find a common response to the problems of regulation of rating agencies. The only argument in favor of "special treatment" by either regulator would have to be derived from a national bias demonstrated by the rating agencies themselves. While some have claimed such bias in favor of US issuers, at least according to the internal statistics of Moody's no such bias could be ascertained. On the contrary, one-year and five-year performance

studies by Moody's of US and European issuers have shown that there is greater reliance on the European ratings that have been assigned (roughly 90% for European vs. 65% for US issuers). According to the data made available by Moody's, the failure rates attached to each rating were slightly higher for European issuers (time-frame 1985-2003) than for US issuers.[227] No bias can be detected and in this respect, regulation should be set for a level playing field.

Currently, German law might prove to have greater stake in creating some checks and balances for the behavior of rating agencies by at least providing for some residual risk of liability. UK law has not been tested in this respect and, thus, given the conflicting case law rating agencies currently act outside all legal regimes.

The view held here is that the key to establishing effective control of rating agencies is to impose judicial restraint at the same time. Thereby, an adjusted control can obtained allowing for a level playing field for all rating agencies regardless of the specific national jurisdiction. Last but not least, a standard four-prong test of limited judicial control to review plausibility of the rating action has been proposed.

Provide financial service providers with some regulatory guidance and regulation has proven useful in enhancing and rationalizing the process. In this sense, the regulatory matrix[228] among the various supervisors and regulators concerning rating agencies still awaits completion. It will be crucial to provide this business field with a coherent framework in order to avoid disparities and

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[227] Detlef Scholz, Moody's Deutschland GmbH, "Stellungnahme von Moody's anlässlich der Anhörung vor dem Finanzausschuss des Deutschen Bundestages zum Thema 'Ratingagenturen'," presented by Detlef Scholz representing Moody's Investors Service, 3. March 2004, page 6-7.

[228] "Originally, the idea of a regulatory matrix was used to refer to the conduct of business regulation in the various fields of financial service providers; Charles Goodhart, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suárez and Steven Weisbrod, "Financial Regulation, Why, how and where now?, forword by Eddie George, (London 1998), 168."

regulatory arbitrage between the various supervisors. To what extent this line of argument will persuade local regulators from "gold-plating" international standards like the ones set from IOSCO remains to be seen .

Public regulators cannot be insulated from political interest group pressures and will always tend towards a national bias for their subjects.[229] Particularly in an area like rating in which discretion is the norm, public interference should be kept to a minimum. The primary goal of rating agency regulation should be to enhance market efficiency; distributional aims should thereby be set aside. Rating agencies serve as a remedy to information asymmetries – much like securities law and supervision[230] – and the leverage that their business provides is simply too important for capital market efficiency to allow political intrusion.

Rationalizing the credit business through ratings will lead to the improved pricing of credit risks. As in the past, the U.S. will lead the further evolution of the capital markets with its rather well-balanced Rating Agency Reform Act. Through such rationalizing regulation, information deficiencies will be reduced[231] and the profitability of banks should, as a result, increase. It is of fundamental necessity that more attention be paid to the rating business with respect to this important function, since the credit allocation mechanism will determine where exactly economies will experience growth in the future.

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[229] Randall S. Kroszner, "The market as international regulator," pp. 399-404 (403), in: *Mastering Finance, The Complete Finance Companion*, ed. G. Bickerstaffe, (London: Financial Times, 1998).

[230] This idea stems from Steven L. Schwarcz, Private Ordering of Public Markets: The Rating Agency Paradox, University of Illinois Law Review, issue no. 1, 2002, 14.

[231] Drukarcyk noted in 1992 that in the US credit was priced based on credit risk as perceived by rating agencies whereas the decentralized structure of credit institutions in Germany would not yet show this clear correlationship. With the advance of credit rating agencies, at least for major borrowers the gap between US and German credit management should not be applicable any more. Jochen Drukarczyk, *Theory und Politik der Finanzierung*, 2nd ed., (München: Vahlen 1992), 327.

Appendix 1: The IOSCO Code of Conduct

"Code of Conduct Fundamentals for Credit Rating Agencies, The Technical Committee of the International Organization of Securities Commissions, December 2004. ANNEX C, Code of Conduct Fundamentals for Credit Rating Agencies, a consultation report of the chairmen's task force of the technical committee of the international organization of securities commissions, October 2004."[232]

[232] The layout of the appendices might differ slightly from the versions printed in official gazettes.

CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

THE TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

INTRODUCTION

Credit rating agencies (CRAs) can play an important role in modern capital markets. CRAs typically opine on the credit risk of issuers of securities and their financial obligations. Given the vast amount of information available to investors today – some of it valuable, some of it not – CRAs can play a useful role in helping investors and others sift through this information, and analyze the credit risks they face when lending to a particular borrower or when purchasing an issuer's debt and debt-like securities. [1]

In September 2003, IOSCO's Technical Committee published a Statement of Principles Regarding the Activities of Credit Rating Agencies.[2] The Principles were designed to be a useful tool for securities regulators, rating agencies and others wishing to articulate the terms and conditions under which CRAs operate and the manner in which opinions of CRAs should be used by market participants. Because CRAs are regulated and operate differently in different jurisdictions, the Principles laid out high-level objectives that rating agencies, regulators, issuers and other market participants should strive toward in order to improve investor protection and the fairness, efficiency and transparency of securities markets and reduce systemic risk. The Principles were designed to apply to all types of CRAs operating in various jurisdictions. However, to take into account the different market, legal and regulatory circumstances in which CRAs operate, and the varying size and business models of CRAs, the manner in which the Principles were to be implemented was left open. The Principles contemplated that a variety of mechanisms could be used, including both market mechanisms and regulation.

Along with the Principles, IOSCO's Technical Committee also published a Report on the Activities of Credit Rating Agencies that outlined the activities of CRAs, the types of regulatory issues that arise relating to these activities, and how the Principles address these issues.[3] The CRA Report highlighted the growing and sometimes controversial importance placed on CRA assessments and opinions, and found that, in some cases, CRAs activities are not always well understood by investors and issuers alike. Given this lack of understanding, and because CRAs typically are subject to little formal regulation or oversight in most jurisdictions, concerns have been raised regarding the manner in which CRAs protect the integrity of the rating process, ensure that investors and issuers are treated fairly, and safeguard confidential material information provided them by issuers.

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[1] CRAs typically provide credit ratings for different types of debts and financial obligations — including, for example, private loans, publicly and privately traded debt securities, preferred shares and other securities that offer a fixed or variable rate of return. For simplicity's sake, the term "debt and debt-like securities" is used herein to refer to debt securities, preferred shares, and other financial obligations of this sort that CRAs rate.

[2] This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCO-PD 151).

[3] This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IO-SCOPD1 53).

Following publication of the CRA Principles, some commenters, including a number of CRAs, suggested that it would be useful if IOSCO were to develop a more specific and detailed code of conduct giving guidance on how the Principles could be implemented in practice. The following Code of Conduct Fundamentals for Credit Rating Agencies is the fruition of this exercise. As with the Principles, with which it should be used, the Code Fundamentals were developed out of discussions among IOSCO members, CRAs, representatives of the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, issuers, and the public at large.[4]

The Code Fundamentals offer a set of robust, practical measures that serve as a guide to and a framework for implementing the Principles' objectives. These measures are the fundamentals which should be included in individual CRA codes of conduct, and the elements contained in the Code Fundamentals should receive the full support of CRA management and be backed by thorough compliance and enforcement mechanisms. However, the measures set forth in the Code Fundamentals are not intended to be all-inclusive: CRAs and regulators should consider whether or not additional measures may be necessary to properly implement the Principles in a specific jurisdiction, and the Technical Committee may revisit the Code Fundamentals in the future should experience dictate that modifications are necessary. Further, the Code Fundamentals are not designed to be rigid or formulistic. They are designed to offer CRAs a degree of flexibility in how these measures are incorporated into the individual codes of conduct of the CRAs themselves, according to each CRA's specific legal and market circumstances. IOSCO Technical Committee members expect CRAs to give full effect to the Code Fundamentals. In order to promote transparency and improve the ability of market participants and regulators to judge whether a CRA has satisfactorily implemented the Code Fundamentals, CRAs should disclose how each provision of the Code Fundamentals is addressed in the CRA's own code of conduct. CRAs should explain if and how their own codes of conduct deviate from the Code Fundamentals and how such deviations nonetheless achieve the objectives laid out in the Code Fundamentals and the IOSCO CRA Principles. This will permit market participants and regulators to draw their own conclusions about whether the CRA has implemented the Code Fundamentals to their satisfaction, and to react accordingly. In developing their own codes of conduct, CRAs should keep in mind that the laws and regulations of the jurisdictions in which they operate vary and take precedence over the Code Fundamentals. These laws and regulations may include direct regulation of CRAs and may incorporate elements of the Code Fundamentals itself.

Finally, the Code Fundamentals only address measures that CRAs should adopt to help ensure that the CRA Principles are properly implemented. The Code Fundamentals do not address the equally important obligations issuers have of cooperating with and providing accurate and complete information to the marketplace and the CRAs they solicit to provide ratings. While aspects of the Code Fundamentals deal with a CRA's duties to issuers, the essential purpose of the Code

[4] A consultation draft of the Code Fundamentals was published for public comment in October 2004. This document (IOSCOPD173) and a list of public comments IOSCO received on the consultation draft (IOSCOPD177) can be downloaded from IOSCO's On-Line Library at www.iosco.org. The online version of the list of public comments includes hyperlinks to the comment letters themselves.

Fundamentals is to promote investor protection by safeguarding the integrity of the rating process. IOSCO members recognize that credit ratings, despite their numerous other uses, exist primarily to help investors assess the credit risks they face when making certain kinds of investments. Maintaining the independence of CRAs vis-à-vis the issuers they rate is vital to achieving this goal. Provisions of the Code Fundamentals dealing with CRA obligations to issuers are designed to improve the quality of credit ratings and their usefulness to investors. These provisions should not be interpreted in ways that undermine the independence of CRAs or their ability to issue timely ratings opinions.

Like the IOSCO CRA Principles, the objectives of which are reflected herein, the Code Fundamentals are also intended to be useful to all types of CRAs relying on a variety of different business models. The Code Fundamentals do not indicate a preference for one business model over another, nor are the measures described therein designed to be used only by CRAs with large staffs and compliance functions. Accordingly, the types of mechanisms and procedures CRAs adopt to ensure that the provisions of the Code Fundamentals are followed will vary according to the market and legal circumstances in which the CRA operates.

Structurally, the Code Fundamentals are broken into three sections and draw upon the organization and substance of the Principles themselves:

~ The Quality and Integrity of the Rating Process;

~ CRA Independence and the Avoidance of Conflicts of Interest; and, ~

CRA Responsibilities to the Investing Public and Issuers.

TERMS

The Code Fundamentals are designed to apply to any CRA and any person employed by a CRA in either a full-time or part-time capacity. A CRA employee who is primarily employed as a credit analyst is referred to as an "analyst." For the purposes of the Code Fundamentals, the terms "CRA" and "credit rating agency" refer to those entities whose business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers of debt and debt-like securities.

For the purposes of the Code Fundamentals, a "credit rating" is an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system. As described in the CRA Report, credit ratings are not recommendations to purchase, sell, or hold any security.

THE IOSCO CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

As described in the IOSCO CRA Principles, CRAs should endeavor to issue opinions that help reduce the asymmetry of information that exists between borrowers and debt and debt-like securities issuers, on one side, and lenders and the purchasers of debt and debt-like securities on the other. Rating analyses of low quality or produced
through a process of questionable integrity are of little use to market participants. Stale ratings that fail to reflect changes to an issuer's financial condition or prospects may mislead market participants. Likewise, conflicts of interest or other undue factors – internal and external – that might, or even appear to, impinge upon the independence of a rating decision can seriously undermine a CRA's credibility. Where conflicts of interest or a lack of independence is common at a CRA and hidden from investors, overall investor confidence in the transparency and integrity of a market can be harmed. CRAs also have responsibilities to the investing public and to issuers themselves, including a responsibility to protect the confidentiality of some types of information issuers share with them.

To help achieve the objectives outlined in the CRA Principles, which should be read in conjunction with the Code Fundamentals, CRAs should adopt, publish and adhere to a Code of Conduct containing the following measures:

1. Quality and Integrity of the Rating Process

A. Quality of the Rating Process

1.1 The CRA should adopt, implement and enforce written procedures to ensure that the opinions it disseminates are based on a thorough analysis of all information known to the CRA that is relevant to its analysis according to the CRA 's published rating methodology.

1.2 The CRA should use rating methodologies that are rigorous, systematic, and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience.

1.3 In assessing an issuer's creditworthiness, analysts involved in the preparation or review of any rating action should use methodologies established by the CRA. Analysts should apply a given methodology in a consistent manner, as determined by the CRA.

1.4 Credit ratings should be assigned by the CRA and not by any individual analyst employed by the CRA; ratings should reflect all information known, and believed to be relevant, to the CRA, consistent with its published methodology; and the CRA should use people who, individually or collectively have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied.

1.5 The CRA should maintain internal records to support its credit opinions for a reasonable period of time or in accordance with applicable law.

1.6 The CRA and its analysts should take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of an issuer or obligation.

1.7 The CRA should ensure that it has and devotes sufficient resources to carry out high-quality credit assessments of all obligations and issuers it rates. When deciding whether to rate or continue rating an obligation or issuer, it should assess whether it is able to devote sufficient personnel with sufficient skill sets to make a proper rating assessment, and whether its personnel likely will have access to sufficient information needed in order make such an assessment.

1.8 The CRA should structure its rating teams to promote continuity and avoid bias in the rating process.

B. Monitoring and Updating

1.9 Except for ratings that clearly indicate they do not entail ongoing surveillance, once a rating is published the CRA should monitor on an ongoing basis and update the rating by:

a. regularly reviewing the issuer's creditworthiness;

b. initiating a review of the status of the rating upon becoming aware of any information that might reasonably be expected to result in a rating action (including termination of a rating), consistent with the applicable rating methodology; and,

c. updating on a timely basis the rating, as appropriate, based on the results of such review.

1.10 Where a CRA makes its ratings available to the public, the CRA should publicly announce if it discontinues rating an issuer or obligation. Where a CRA's ratings are provided only to its subscribers, the CRA should announce to its subscribers if it discontinues rating an issuer or obligation. In both cases, continuing publications by the CRA of the discontinued rating should indicate the date the rating was last updated and the fact that the rating is no longer being updated.

C. Integrity of the Rating Process

1.11 The CRA and its employees should comply with all applicable laws and regulations governing its activities in each jurisdiction in which it operates.

1.12 The CRA and its employees should deal fairly and honestly with issuers, investors, other market participants, and the public.

1.13 The CRA's analysts should be held to high standards of integrity, and the CRA should not employ individuals with demonstrably compromised integrity.

1.14 The CRA and its employees should not, either implicitly or explicitly, give any assurance or guarantee of a particular rating prior to a rating assessment. This does not preclude a CRA from developing prospective assessments used in structured finance and similar transactions.

1.15 The CRA should institute policies and procedures that clearly specify a person responsible for the CRA's and the CRA's employees' compliance with the provisions of the CRA's code of conduct and with applicable laws and regulations. This person's reporting lines and compensation should be independent of the CRA's rating operations.

1.16 Upon becoming aware that another employee or entity under common control with the CRA is or has engaged in conduct that is illegal, unethical or contrary to the CRA 's code of conduct, a CRA employee should report such information immediately to the individual in charge of compliance or an officer of the CRA, as appropriate, so proper action may be taken. A CRA's employees are not necessarily expected to be experts in the law. Nonetheless, its employees are expected to report the activities that a reasonable person would question. Any CRA officer who receives such a report from a CRA employee is obligated to take appropriate action, as determined by the laws and regulations of the jurisdiction and the rules and guidelines set forth by the CRA. CRA management should prohibit retaliation by other CRA staff or by the CRA itself against any employees who, in good faith, make such reports.

2. CRA INDEPENDENCE AND AVOIDANCE OF CONFLICTS OF INTEREST

A. General

2.1 The CRA should not forbear or refrain from taking a rating action based on the potential effect (economic, political, or otherwise) of the action on the CRA, an issuer, an investor, or other market participant.

2.2 The CRA and its analysts should use care and professional judgment to maintain both the substance and appearance of independence and objectivity.

2.3 The determination of a credit rating should be influenced only by factors relevant to the credit assessment.

2.4 The credit rating a CRA assigns to an issuer or security should not be affected by the existence of or potential for a business relationship between the CRA (or its affiliates) and the issuer (or its affiliates) or any other party, or the non-existence of such a relationship.

2.5 The CRA should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest. The CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA 's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise.

B. CRA Procedures and Policies

2.6 The CRA should adopt written internal procedures and mechanisms to (1) identify, and (2) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the opinions and analyses the CRA makes or the judgment and analyses of the individuals the CRA employs who have an influence on ratings decisions. The CRA's code of conduct should also state that the CRA will disclose such conflict avoidance and management measures.

2.7 The CRA's disclosures of actual and potential conflicts of interest should be complete, timely, clear, concise, specific and prominent.

2.8 The CRA should disclose the general nature of its compensation arrangements with rated entities. Where a CRA receives from a rated entity compensation unrelated to its ratings service, such as compensation for consulting services, the CRA should disclose the proportion such non-rating fees constitute against the fees the CRA receives from the entity for ratings services.

2.9 The CRA and its employees should not engage in any securities or derivatives trading presenting conflicts of interest with the CRA's rating activities.

2.10 In instances where rated entities (e.g., governments) have, or are simultaneously pursuing, oversight functions related to the CRA, the CRA should use different employees to conduct its rating actions than those employees involved in its oversight issues.

C. CRA Analyst and Employee Independence

2.11 Reporting lines for CRA employees and their compensation arrangements should be structured to eliminate or effectively manage actual and potential conflicts of interest. The CRA's code of conduct should also state that a CRA analyst will not be compen-

sated or evaluated on the basis of the amount of revenue that the CRA derives from issuers that the analyst rates or with which the analyst regularly interacts.

2.12 The CRA should not have employees who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate.

2.13 No CRA employee should participate in or otherwise influence the determination of the CRA's rating of any particular entity or obligation if the employee:

a. Owns securities or derivatives of the rated entity, other than holdings in diversified collective investment schemes;

b. Owns securities or derivatives of any entity related to a rated entity, the ownership of which may cause or may be perceived as causing a conflict of interest, other than holdings in diversified collective investment schemes;

c. Has had a recent employment or other significant business relationship with the rated entity that may cause or may be perceived as causing a conflict of interest;

d. Has an immediate relation (i.e., a spouse, partner, parent, child, or sibling) who currently works for the rated entity; or

e. Has, or had, any other relationship with the rated entity or any related entity thereof that may cause or may be perceived as causing a conflict of interest.

2.14 The CRA's analysts and anyone involved in the rating process (or their spouse, partner or minor children) should not buy or sell or engage in any transaction in any security or derivative based on a security issued, guaranteed, or otherwise supported by any entity within such analyst's area of primary analytical responsibility, other than holdings in diversified collective investment schemes.

2.15 CRA employees should be prohibited from soliciting money, gifts or favors from anyone with whom the CRA does business and should be prohibited from accepting gifts offered in the form of cash or any gifts exceeding a minimal monetary value.

2.16 Any CRA analyst who becomes involved in any personal relationship that creates the potential for any real or apparent conflict of interest (including, for example, any personal relationship with an employee of a rated entity or agent of such entity within his or her area of analytic responsibility), should be required to disclose such relationship to the appropriate manager or officer of the CRA, as determined by the CRA's compliance policies.

3. CRA RESPONSIBILITIES TO THE INVESTING PUBLIC AND ISSUERS

A. Transparency and Timeliness of Ratings Disclosure

3.1 The CRA should distribute in a timely manner its ratings decisions regarding the entities and securities it rates.

3.2 The CRA should publicly disclose its policies for distributing ratings, reports and updates.

3.3 The CRA should indicate with each of its ratings when the rating was last updated.

3.4 Except for "private ratings" provided only to the issuer, the CRA should disclose to the public, on a non-selective basis and free of charge, anyrating regarding publicly issued securities, or public issuers themselves, as well as any subsequent decisions to discontinue such a rating, if the rating action is based in whole or in part on material non-public information.

3.5 The CRA should publish sufficient information about its procedures, methodologies and assumptions (including financial statement adjustments that deviate materially from those contained in the issuer's published financial statements) so that outside parties can understand how a rating was arrived at by the CRA. This information will include (but not be limited to) the meaning of each rating category and the definition of default or recovery, and the time horizon the CRA used when making a rating decision.

3.6 When issuing or revising a rating, the CRA should explain in its press releases and reports the key elements underlying the rating opinion.

3.7 Where feasible and appropriate, prior to issuing or revising a rating, the CRA should inform the issuer of the critical information and principal considerations upon which a rating will be based and afford the issuer an opportunity to clarify any likely factual misperceptions or other matters that the CRA would wish to be made aware of in order to produce an accurate rating. The CRA will duly evaluate the response. Where in particular circumstances the CRA has not informed the issuer prior to issuing or revising a rating, the CRA should inform the issuer as soon as practical thereafter and, generally, should explain the reason for the delay.

3.8 In order to promote transparency and to enable the market to best judge the performance of the ratings, the CRA, where possible, should publish suficient information about the historical default rates of CRA rating categories and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category and if and how rating categories have changed, and be able to draw quality comparisons among ratings given by dif-

ferent CRAs. If the nature of the rating or other circumstances make a historical default rate inappropriate, statistically invalid, or otherwise likely to mislead the users of the rating, the CRA should explain this.

3.9 For each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be identified as such. The CRA should also disclose its policies and procedures regarding unsolicited ratings.

3.10 Because users of credit ratings rely on an existing awareness of CRA methodologies, practices, procedures and processes, the CRA should fully and publicly disclose any material modification to its methodologies and significant practices, procedures, and processes. Where feasible and appropriate, disclosure of such material modifications should be made prior to their going into effect. The CRA should carefully consider the various uses of credit ratings before modifying its methodologies, practices, procedures and processes.

B. The Treatment of Confidential Information

3.11 The CRA should adopt procedures and mechanisms to protect the confidential nature of information shared with them by issuers under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially. Unless otherwise permitted by the confidentiality agreement and consistent with applicable laws or regulations, the CRA and its employees should not disclose confidential information in press releases, through research conferences, to future employers, or in conversations with investors, other issuers, other persons, or otherwise.

3.12 The CRA should use confidential information only for purposes related to its rating activities or otherwise in accordance with any confidentiality agreements with the issuer.

3.13 CRA employees should take all reasonable measures to protect all property and records belonging to or in possession of the CRA from fraud, theft or misuse.

3.14 CRA employees should be prohibited from engaging in transactions in securities when they possess confidential information concerning the issuer of such security.

3.15 In preservation of confidential information, CRA employees should familiarize themselves with the internal securities trading policies maintained by their employer, and periodically certify their compliance as required by such policies.

3.16 CRA employees should not selectively disclose any non-public information about rating opinions or possible future rating actions of the CRA, except to the issuer or its designated agents.

3.17 CRA employees should not share confidential information entrusted to the CRA with employees of any affiliated entities that are not CRAs. CRA employees should not share confidential information within the CRA except on an "as needed" basis.

3.18 CRA employees should not use or share confidential information for the purpose of trading securities, or for any other purpose except the conduct of the CRA's business.

4. DISCLOSURE OF THE CODE OF CONDUCT AND COMMUNICATION WITH MARKET PARTICIPANTS

4.1 *The CRA should disclose to the public its code of conduct and describe how the provisions of its code of conduct fully implement the provisions of the IOSCO Principles Regarding the Activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. If a CRA's code of conduct deviates from the IOSCO provisions, the CRA should explain where and why these deviations exist, and how any deviations nonetheless achieve the objectives contained in the IOSCO provisions. The CRA should also describe generally how it intends to enforce its code of conduct and should disclose on a timely basis any changes to its code of conduct or how it is implemented and enforced.*

4.2 The CRA should establish a function within its organization charged with communicating with market participants and the public about any questions, concerns or complaints that the CRA may receive. The objective of this function should be to help ensure that the CRA's officers and management are informed of those issues that the CRA's officers and management would want to be made aware of when setting the organization's policies.

Appendix 2: The Credit Rating Agency Reform Act of 2006

"The Credit Rating Agency Reform Act", 109th U.S. Congress, Bill Number S. 3850, signed by the President on Sept. 29, 2006.

Note: The "Credit Rating Agency Duopoly Relief Act of 2006" (H.R. 2990) contained many similar provisions but never became law.

One Hundred Ninth Congress

of the

United States of America

AT THE SECOND SESSION

Begun and held at the City of Washington on Tuesday, the third day of January, two thousand and six

An Act

To improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the `Credit Rating Agency Reform Act of 2006'.

SEC. 2. FINDINGS.

Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission made pursuant to section 702 of the Sarbanes-Oxley Act of 2002 (116 Stat. 797), hearings before the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives during the 108th and 109th Congresses, comment letters to the concept releases and proposed rules of the Commission, and facts otherwise disclosed and ascertained, Congress finds that

credit rating agencies are of national importance, in that, among other things--

(1) their ratings, publications, writings, analyses, and reports are furnished and distributed, and their contracts, subscription agreements, and other arrangements with clients are negotiated and performed, by the use of the mails and other means and instrumentalities of interstate commerce;

(2) their ratings, publications, writings, analyses, and reports customarily relate to the purchase and sale of securities traded on securities exchanges and in interstate over-the-counter markets, securities issued by companies engaged in business in interstate commerce, and securities issued by national banks and member banks of the Federal Reserve System;

(3) the foregoing transactions occur in such volume as substantially to affect interstate commerce, the securities markets, the national banking system, and the national economy;

(4) the oversight of such credit rating agencies serves the compelling interest of investor protection;

(5) the 2 largest credit rating agencies serve the vast majority of the market, and additional competition is in the public interest; and

(6) the Commission has indicated that it needs statutory authority to oversee the credit rating industry.

SEC. 3. DEFINITIONS.

(a) Securities Exchange Act of 1934- Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end the following new paragraphs:

(60) CREDIT RATING- The term `credit rating' means an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments.

(61) CREDIT RATING AGENCY- The term `credit rating agency' means any person--

(A) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company;

(B) employing either a quantitative or qualitative model, or both, to determine credit ratings; and

(C) receiving fees from either issuers, investors, or other market participants, or a combination thereof.

(62) NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION- The term `nationally recognized statistical rating organization' means a credit rating agency that-

(A) has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under section 15E;

(B) issues credit ratings certified by qualified institutional buyers, in accordance with section 15E(a)(1)(B)(ix), with respect to--

(i) financial institutions, brokers, or dealers;

(ii) insurance companies;

(iii) corporate issuers;

(iv) issuers of asset-backed securities (as that term is defined in section 1101(c) of part 229 of title 17, Code of Federal Regulations, as in effect on the date of enactment of this paragraph);

(v) issuers of government securities, municipal securities, or securities issued by a foreign government; or

(vi) a combination of one or more categories of obligors described in any of clauses (i) through (v); and

(C) is registered under section 15E.

(63) PERSON ASSOCIATED WITH A NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION- The term `person associated with' a nationally recognized statistical rating organization means any partner, officer, director, or branch manager of a nationally recognized statistical rating organization (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with a nationally recognized statistical rating organization, or any employee of a nationally recognized statistical rating organization.

(64) QUALIFIED INSTITUTIONAL BUYER- The term `qualified institutional buyer' has the meaning given such term in section 230.144A(a) of title 17, Code of Federal Regulations, or any successor thereto.'.

(b) Applicable Definitions- As used in this Act--

(1) the term `Commission' means the Securities and Exchange Commission; and

(2) the term `nationally recognized statistical rating organization' has the same meaning as in section 3(a)(62) of the Securities Exchange Act of 1934, as added by this Act.

SEC. 4. REGISTRATION OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS.

(a) Amendment- The Securities Exchange Act of 1934 is amended by inserting after section 15D (15 U.S.C. 78o-6) the following new section:

`SEC. 15E. REGISTRATION OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS.

(a) Registration Procedures-

(1) APPLICATION FOR REGISTRATION-

(A) IN GENERAL- A credit rating agency that elects to be treated as a nationally recognized statistical rating organization for purposes of this title (in this section referred to as the `applicant'), shall furnish to the Commission an application for registration, in such form as the Commission shall require, by rule or regulation issued in accordance with subsection (n), and containing the information described in subparagraph (B).

(B) REQUIRED INFORMATION- An application for registration under this section shall contain information regarding--

(i) credit ratings performance measurement statistics over short-term, mid-term, and long-term periods (as applicable) of the applicant;

(ii) the procedures and methodologies that the applicant uses in determining credit ratings;

(iii) policies or procedures adopted and implemented by the applicant to prevent the misuse, in violation of this title (or the rules and regulations hereunder), of material, nonpublic information;

(iv) the organizational structure of the applicant;

(v) whether or not the applicant has in effect a code of ethics, and if not, the reasons therefor;

(vi) any conflict of interest relating to the issuance of credit ratings by the applicant;

(vii) the categories described in any of clauses (i) through (v) of section 3(a)(62)(B) with re-

spect to which the applicant intends to apply for registration under this section;

(viii) on a confidential basis, a list of the 20 largest issuers and subscribers that use the credit rating services of the applicant, by amount of net revenues received therefrom in the fiscal year immediately preceding the date of submission of the application;

(ix) on a confidential basis, as to each applicable category of obligor described in any of clauses (i) through (v) of section 3(a)(62)(B), written certifications described in subparagraph (C), except as provided in subparagraph (D); and

(x) any other information and documents concerning the applicant and any person associated with such applicant as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(C) WRITTEN CERTIFICATIONS- Written certifications required by subparagraph (B)(ix)--

(i) shall be provided from not fewer than 10 qualified institutional buyers, none of which is affiliated with the applicant;

(ii) may address more than one category of obligors described in any of clauses (i) through (v) of section 3(a)(62)(B);

(iii) shall include not fewer than 2 certifications for each such category of obligor; and

(iv) shall state that the qualified institutional buyer--

(I) meets the definition of a qualified institutional buyer under section 3(a)(64); and

(II) has used the credit ratings of the applicant for at least the 3 years immediately preceding the date of the certification in the subject category or categories of obligors.

(D) EXEMPTION FROM CERTIFICATION REQUIREMENT- A written certification under subparagraph (B)(ix) is not required with respect to any credit rating agency which has received, or been the subject of, a no-action letter from the staff of the Commission prior to August 2, 2006, stating that such staff would not recommend enforcement action against any broker or dealer that considers credit ratings issued by such credit rating agency to be ratings from a nationally recognized statistical rating organization.

(E) LIMITATION ON LIABILITY OF QUALIFIED INSTITUTIONAL BUYERS- No qualified institutional buyer shall be liable in any private right of action for any opinion or statement expressed in a certification made pursuant to subparagraph (B)(ix).

(2) REVIEW OF APPLICATION-

(A) INITIAL DETERMINATION- Not later than 90 days after the date on which the application for registration is furnished to the Commission under paragraph (1) (or within such longer period as to which the applicant consents) the Commission shall -

(i) by order, grant such registration for ratings in the subject category or categories of obligors, as described in clauses (i) through (v) of section 3(a)(62)(B); or

(ii) institute proceedings to determine whether registration should be denied.

(B) CONDUCT OF PROCEEDINGS-

(i) CONTENT- Proceedings referred to in subparagraph (A)(ii) shall--

(I) include notice of the grounds for denial under consideration and an opportunity for hearing; and

(II) be concluded not later than 120 days after the date on which the application for registration is furnished to the Commission under paragraph (1).

(ii) DETERMINATION- At the conclusion of such proceedings, the Commission, by order, shall grant or deny such application for registration.

(iii) EXTENSION AUTHORIZED- The Commission may extend the time for conclusion of such proceedings for not longer than 90 days, if it finds good cause for such extension and publishes its reasons for so finding, or for such longer period as to which the applicant consents.

(C) GROUNDS FOR DECISION- The Commission shall grant registration under this subsection--

(i) if the Commission finds that the requirements of this section are satisfied; and

(ii) unless the Commission finds (in which case the Commission shall deny such registration) that--

(I) the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and meth-

odologies disclosed under paragraph (1)(B) and with subsections (g), (h), (i), and (j); or

(II) if the applicant were so registered, its registration would be subject to suspension or revocation under subsection (d).

(3) PUBLIC AVAILABILITY OF INFORMATION- Subject to section 24, the Commission shall, by rule, require a nationally recognized statistical rating organization, upon the granting of registration under this section, to make the information and documents submitted to the Commission in its completed application for registration, or in any amendment submitted under paragraph (1) or (2) of subsection (b), publicly available on its website, or through another comparable, readily accessible means, except as provided in clauses (viii) and (ix) of paragraph (1)(B).

(b) Update of Registration-

(1) UPDATE- Each nationally recognized statistical rating organization shall promptly amend its application for registration under this section if any information or document provided therein becomes materially inaccurate, except that a nationally recognized statistical rating organization is not required to amend--

(A) the information required to be furnished under subsection (a)(1)(B)(i) by furnishing information under this paragraph, but shall amend such information in the annual submission of the organization under paragraph (2) of this subsection; or

(B) the certifications required to be provided under subsection (a)(1)(B)(ix) by furnishing information under this paragraph.

(2) CERTIFICATION- Not later than 90 days after the end of each calendar year, each nationally recognized statistical rating organization shall furnish to the Commission an amend-

ment to its registration, in such form as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors--

(A) certifying that the information and documents in the application for registration of such nationally recognized statistical rating organization (other than the certifications required under subsection (a)(1)(B)(ix)) continue to be accurate; and

(B) listing any material change that occurred to such information or documents during the previous calendar year.

(c) Accountability for Ratings Procedures-

(1) AUTHORITY- The Commission shall have exclusive authority to enforce the provisions of this section in accordance with this title with respect to any nationally recognized statistical rating organization, if such nationally recognized statistical rating organization issues credit ratings in material contravention of those procedures relating to such nationally recognized statistical rating organization, including procedures relating to the prevention of misuse of nonpublic information and conflicts of interest, that such nationally recognized statistical rating organization--

(A) includes in its application for registration under subsection (a)(1)(B)(ii); or

(B) makes and disseminates in reports pursuant to section 17(a) or the rules and regulations thereunder.

(2) LIMITATION- The rules and regulations that the Commission may prescribe pursuant to this title, as they apply to nationally recognized statistical rating organizations, shall be narrowly tailored to meet the requirements of this title applicable to nationally recognized statistical rating organizations. Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures

and methodologies by which any nationally recognized statistical rating organization determines credit ratings.

(d) Censure, Denial, or Suspension of Registration; Notice and Hearing- The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any nationally recognized statistical rating organization if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is necessary for the protection of investors and in the public interest and that such nationally recognized statistical rating organization, or any person associated with such an organization, whether prior to or subsequent to becoming so associated--

(1) has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph (A), (D), (E), (H), or (G) of section 15(b)(4), has been convicted of any offense specified in section 15(b)(4)(B), or is enjoined from any action, conduct, or practice specified in subparagraph (C) of section 15(b)(4), during the 10-year period preceding the date of commencement of the proceedings under this subsection, or at any time thereafter;

(2) has been convicted during the 10-year period preceding the date on which an application for registration is furnished to the Commission under this section, or at any time thereafter, of--

(A) any crime that is punishable by imprisonment for 1 or more years, and that is not described in section 15(b)(4)(B); or

(B) a substantially equivalent crime by a foreign court of competent jurisdiction;

(3) is subject to any order of the Commission barring or suspending the right of the person to be associated with a nationally recognized statistical rating organization;

(4) fails to furnish the certifications required under subsection (b)(2); or

(5) fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.

(e) Termination of Registration-

(1) VOLUNTARY WITHDRAWAL- A nationally recognized statistical rating organization may, upon such terms and conditions as the Commission may establish as necessary in the public interest or for the protection of investors, withdraw from registration by furnishing a written notice of withdrawal to the Commission.

(2) COMMISSION AUTHORITY- In addition to any other authority of the Commission under this title, if the Commission finds that a nationally recognized statistical rating organization is no longer in existence or has ceased to do business as a credit rating agency, the Commission, by order, shall cancel the registration under this section of such nationally recognized statistical rating organization.

(f) Representations-

(1) BAN ON REPRESENTATIONS OF SPONSORSHIP BY UNITED STATES OR AGENCY THEREOF- It shall be unlawful for any nationally recognized statistical rating organization to represent or imply in any manner whatsoever that such nationally recognized statistical rating organization has been designated, sponsored, recommended, or approved, or that the abilities or qualifications thereof have in any respect been passed upon, by the United States or any agency, officer, or employee thereof.

(2) BAN ON REPRESENTATION AS NRSRO OF UNREGISTERED CREDIT RATING AGENCIES- It shall be unlawful for any credit rating agency that is not registered under this section as a nationally recognized statistical rating organization to state that such credit rating agency is a nationally recognized statistical rating organization registered under this title.

(3) STATEMENT OF REGISTRATION UNDER SECURITIES EXCHANGE ACT OF 1934 PROVISIONS- No provision of

paragraph (1) shall be construed to prohibit a statement that a nationally recognized statistical rating organization is a nationally recognized statistical rating organization under this title, if such statement is true in fact and if the effect of such registration is not misrepresented.

(g) Prevention of Misuse of Nonpublic Information-

(1) ORGANIZATION POLICIES AND PROCEDURES- Each nationally recognized statistical rating organization shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such nationally recognized statistical rating organization, to prevent the misuse in violation of this title, or the rules or regulations hereunder, of material, nonpublic information by such nationally recognized statistical rating organization or any person associated with such nationally recognized statistical rating organization.

(2) COMMISSION AUTHORITY- The Commission shall issue final rules in accordance with subsection (n) to require specific policies or procedures that are reasonably designed to prevent misuse in violation of this title (or the rules or regulations hereunder) of material, nonpublic information.

(h) Management of Conflicts of Interest-

(1) ORGANIZATION POLICIES AND PROCEDURES- Each nationally recognized statistical rating organization shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such nationally recognized statistical rating organization and affiliated persons and affiliated companies thereof, to address and manage any conflicts of interest that can arise from such business.

(2) COMMISSION AUTHORITY- The Commission shall issue final rules in accordance with subsection (n) to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by a nationally recognized statistical rating organization, including, without limitation, conflicts of interest relating to--

(A) the manner in which a nationally recognized statistical rating organization is compensated by the obligor, or any affiliate of the obligor, for issuing credit ratings or providing related services;

(B) the provision of consulting, advisory, or other services by a nationally recognized statistical rating organization, or any person associated with such nationally recognized statistical rating organization, to the obligor, or any affiliate of the obligor;

(C) business relationships, ownership interests, or any other financial or personal interests between a nationally recognized statistical rating organization, or any person associated with such nationally recognized statistical rating organization, and the obligor, or any affiliate of the obligor;

(D) any affiliation of a nationally recognized statistical rating organization, or any person associated with such nationally recognized statistical rating organization, with any person that underwrites the securities or money market instruments that are the subject of a credit rating; and

(E) any other potential conflict of interest, as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

(i) Prohibited Conduct-

(1) PROHIBITED ACTS AND PRACTICES- The Commission shall issue final rules in accordance with subsection (n) to prohibit any act or practice relating to the issuance of credit ratings by a nationally recognized statistical rating organization that the Commission determines to be unfair, coercive, or abusive, including any act or practice relating to--

(A) conditioning or threatening to condition the issuance of a credit rating on the purchase by the obligor or an affiliate thereof of other services or products, including pre-credit rating assessment products, of the

nationally recognized statistical rating organization or any person associated with such nationally recognized statistical rating organization;

(B) lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets within such pool or part of such transaction, as applicable, also is rated by the nationally recognized statistical rating organization; or

(C) modifying or threatening to modify a credit rating or otherwise departing from its adopted systematic procedures and methodologies in determining credit ratings, based on whether the obligor, or an affiliate of the obligor, purchases or will purchase the credit rating or any other service or product of the nationally recognized statistical rating organization or any person associated with such organization.

(2) RULE OF CONSTRUCTION- Nothing in paragraph (1), or in any rules or regulations adopted thereunder, may be construed to modify, impair, or supersede the operation of any of the antitrust laws (as defined in the first section of the Clayton Act, except that such term includes section 5 of the Federal Trade Commission Act, to the extent that such section 5 applies to unfair methods of competition).

(j) Designation of Compliance Officer- Each nationally recognized statistical rating organization shall designate an individual responsible for administering the policies and procedures that are required to be established pursuant to subsections (g) and (h), and for ensuring compliance with the securities laws and the rules and regulations thereunder, including those promulgated by the Commission pursuant to this section.

(k) Statements of Financial Condition- Each nationally recognized statistical rating organization shall, on a confidential basis, furnish to the Commission, at intervals determined by the Commission, such financial statements, certified (if required by the rules or regulations of the Commission) by an independent public accountant, and in-

formation concerning its financial condition, as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(l) Sole Method of Registration-

(1) IN GENERAL- On and after the effective date of this section, a credit rating agency may only be registered as a nationally recognized statistical rating organization for any purpose in accordance with this section.

(2) PROHIBITION ON RELIANCE ON NO-ACTION RELIEF- On and after the effective date of this section--

(A) an entity that, before that date, received advice, approval, or a no-action letter from the Commission or staff thereof to be treated as a nationally recognized statistical rating organization pursuant to the Commission rule at section 240.15c3-1 of title 17, Code of Federal Regulations, may represent itself or act as a nationally recognized statistical rating organization only--

(i) during Commission consideration of the application, if such entity has furnished an application for registration under this section; and

(ii) on and after the date of approval of its application for registration under this section; and

(B) the advice, approval, or no-action letter described in subparagraph (A) shall be void.

(3) NOTICE TO OTHER AGENCIES- Not later than 30 days after the date of enactment of this section, the Commission shall give notice of the actions undertaken pursuant to this section to each Federal agency which employs in its rules and regulations the term `nationally recognized statistical rating organization' (as that term is used under Commission rule 15c3-1 (17 C.F.R. 240.15c3-1), as in effect on the date of enactment of this section).

(m) Rules of Construction-

(1) NO WAIVER OF RIGHTS, PRIVILEGES, OR DEFENSES- Registration under and compliance with this section does not constitute a waiver of, or otherwise diminish, any right, privilege, or defense that a nationally recognized statistical rating organization may otherwise have under any provision of State or Federal law, including any rule, regulation, or order thereunder.

(2) NO PRIVATE RIGHT OF ACTION- Nothing in this section may be construed as creating any private right of action, and no report furnished by a nationally recognized statistical rating organization in accordance with this section or section 17 shall create a private right of action under section 18 or any other provision of law.

(n) Regulations-

(1) NEW PROVISIONS- Such rules and regulations as are required by this section or are otherwise necessary to carry out this section, including the application form required under subsection (a)--

(A) shall be issued by the Commission in final form, not later than 270 days after the date of enactment of this section; and

(B) shall become effective not later than 270 days after the date of enactment of this section.

(2) REVIEW OF EXISTING REGULATIONS- Not later than 270 days after the date of enactment of this section, the Commission shall--

(A) review its existing rules and regulations which employ the term `nationally recognized statistical rating organization' or `NRSRO'; and

(B) amend or revise such rules and regulations in accordance with the purposes of this section, as the Commission may prescribe as necessary or appropri-

ate in the public interest or for the protection of investors.

(o) NRSROs Subject to Commission Authority-

(1) IN GENERAL- No provision of the laws of any State or political subdivision thereof requiring the registration, licensing, or qualification as a credit rating agency or a nationally recognized statistical rating organization shall apply to any nationally recognized statistical rating organization or person employed by or working under the control of a nationally recognized statistical rating organization.

(2) LIMITATION- Nothing in this subsection prohibits the securities commission (or any agency or office performing like functions) of any State from investigating and bringing an enforcement action with respect to fraud or deceit against any nationally recognized statistical rating organization or person associated with a nationally recognized statistical rating organization.

(p) Applicability- This section, other than subsection (n), which shall apply on the date of enactment of this section, shall apply on the earlier of--

(1) the date on which regulations are issued in final form under subsection (n)(1); or

(2) 270 days after the date of enactment of this section.'.

(b) Conforming Amendments-

(1) SECURITIES EXCHANGE ACT OF 1934- The Securities Exchange Act of 1934 (15 U.S.C. 78 et seq.) is amended--

(A) in section 15(b)(4) (15 U.S.C. 78o(b)(4))--

(i) in subparagraph (B)(ii), by inserting `nationally recognized statistical rating organization,' after `transfer agent,'; and

(ii) in subparagraph (C), by inserting `nationally recognized statistical rating organization,' after `transfer agent,'; and

(B) in section 21B(a) (15 U.S.C. 78u-2(a)), by inserting `15E,' after `15C,'.

(2) INVESTMENT COMPANY ACT OF 1940- The Investment Company Act of 1940 (15 U.S.C. 80a et seq.) is amended--

(A) in section 2(a) (15 U.S.C. 80a-2(a)), by adding at the end the following new paragraph:

(53) The term `credit rating agency' has the same meaning as in section 3 of the Securities Exchange Act of 1934.'; and

(B) in section 9(a) (15 U.S.C. 80a-9(a))--

(i) in paragraph (1), by inserting `credit rating agency,' after `transfer agent,'; and

(ii) in paragraph (2), by inserting `credit rating agency,' after `transfer agent,'.

(3) INVESTMENT ADVISERS ACT OF 1940- The Investment Advisers Act of 1940 (15 U.S.C. 80b et seq.) is amended--

(A) in section 202(a) (15 U.S.C. 80b-2(a)), by adding at the end the following new paragraph:

(28) The term `credit rating agency' has the same meaning as in section 3 of the Securities Exchange Act of 1934.';

(B) in section 202(a)(11) (15 U.S.C. 80b-2(a)(11)), by striking `or (F)' and inserting the following: `(F) any nationally recognized statistical rating organization, as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934, unless such organization engages in issuing recommendations as to purchasing, selling, or holding securities or in managing assets, consisting in whole or in part of securities, on behalf of others; or (G)'; and

(C) in section 203(e) (15 U.S.C. 80b-3(e))--

(i) in paragraph (2)(B), by inserting `credit rating agency,' after `transfer agent,'; and

(ii) in paragraph (4), by inserting `credit rating agency,' after `transfer agent,'.

(4) HOUSING AND COMMUNITY DEVELOPMENT ACT OF 1992- Section 1319 of the Housing and Community Development Act of 1992 (12 U.S.C. 4519) is amended by striking `effectively' and all that follows through `broker-dealers' and inserting `that is a nationally recognized statistical rating organization, as such term is defined in section 3(a) of the Securities Exchange Act of 1934'.

(5) HIGHER EDUCATION ACT OF 1965- Section 439(r)(15)(A) of the Higher Education Act of 1965 (20 U.S.C. 1087-2(r)(15)(A)) is amended by striking `means any entity recognized as such by the Securities and Exchange Commission' and inserting `means any nationally recognized statistical rating organization, as that term is defined in section 3(a) of the Securities Exchange Act of 1934'.

(6) TITLE 23- Section 181(11) of title 23, United States Code, is amended by striking `identified by the Securities and Exchange Commission as a nationally recognized statistical rating organization' and inserting `registered with the Securities and Exchange Commission as a nationally recognized statistical rating organization, as that term is defined in section 3(a) of the Securities Exchange Act of 1934'.

SEC. 5. ANNUAL AND OTHER REPORTS.

Section 17(a)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78q(a)(1)) is amended--

(1) by inserting `nationally recognized statistical rating organization,' after `registered transfer agent,'; and

(2) by adding at the end the following: `Any report that a nationally recognized statistical rating organization is required

by Commission rules under this paragraph to make and disseminate to the Commission shall be deemed furnished to the Commission.'.

SEC. 6. COMMISSION ANNUAL REPORT.

The Commission shall submit an annual report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives that, with respect to the year to which the report relates--

(1) identifies applicants for registration under section 15E of the Securities Exchange Act of 1934, as added by this Act;

(2) specifies the number of and actions taken on such applications; and

(3) specifies the views of the Commission on the state of competition, transparency, and conflicts of interest among nationally recognized statistical rating organizations.

SEC. 7. GAO STUDY AND REPORT REGARDING NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS.

(a) Study Required- The Comptroller General of the United States shall conduct a study--

(1) to determine the impact of this Act and the amendments made by this Act on--

(A) the quality of credit ratings issued by nationally recognized statistical ratings organizations;

(B) the financial markets;

(C) competition among credit rating agencies;

(D) the incidence of inappropriate conflicts of interest and sales practices by nationally recognized statistical rating organizations;

(E) the process for registering as a nationally recognized statistical rating organization; and

(F) such other matters relevant to the implementation of this Act and the amendments made by this Act, as the Comptroller General deems necessary to bring to the attention of the Congress;

(2) to identify problems, if any, that have resulted from the implementation of this Act and the amendments made by this Act; and

(3) to recommend solutions, including any legislative or regulatory solutions, to any problems identified under paragraphs (1) and (2).

(b) Report Required- Not earlier than 3 years nor later than 4 years after the date of enactment of this Act, the Comptroller General shall submit a report on the results of the study required by this section to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.

Speaker of the House of Representatives.

Vice President of the United States and

President of the Senate.

Appendix 3: Communication from the Commission on Credit Rating Agencies (2006/C 5 9/02)

C 59/2 EN Official Journal of the European Union 11.3.2006

Communication from the Commission on Credit Rating Agencies

(2006/C 5 9/02)

(Text with EEA relevance)

1. **INTRODUCTION**

Credit rating agencies play a vital role in global securities and banking markets. It is essential, therefore, that they consistently provide ratings which are independent, objective and of the highest possible quality.

The Commission made a commitment to analyse the issue of credit rating agencies at the Oviedo Informal ECOFIN Council (April 2002), in the aftermath of the Enron scandal. The European Parliament then adopted (February 2004) a Resolution on credit rating agencies ([1]), following an own initiative report from its Committee on Economic and Monetary Affairs ([2]), calling on the Commission to produce an assessment of the need (if any) for legislative intervention in this field. In March 2004, following the Parmalat scandal, the Commission identified, in cooperation with the European Parliament and the Member States, the main regulatory issues of concern with regard to credit rating agencies. In July 2004, the Commission asked the Committee of European Securities Regulators ('CESR') to provide the Commission with technical analysis and advice to assess the need for introducing European legislation or other solutions. CESR provided its advice to the Commission in March 2005 ([3]). Meanwhile, a number of key EU legislative measures with major implications for credit rating agencies have been adopted as part of the Commission's Financial Services Action Plan (FSAP). Moreover, the International Organisation of Securities Commissions ('IOSCO') published in December 2004 its Code of Conduct Fundamentals for credit rating agencies ('IOSCO Code') ([4]).

The purpose of this Communication is to report back to the Council and European Parliament on the Commission's regulatory approach towards credit rating agencies, bearing in mind these latest developments. In developing this approach, the Commission has been guided by the advice provided by CESR. It has also sought to adhere to the principles of 'Better Regulation' to which the Commission has committed itself as part of the drive to boost growth and employment in the Union and which form a crucial part of its approach to financial services policy set out in its recent White Paper ([5]).

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[1] European Parliament resolution on Role and methods of rating agencies (2003/208 1 (INI)), available at: http://www.europarl.eu.int/registre/seance_pleniere/textes_adoptes/ definitif/2004/0210/0080/P5_TA(2004)0080_EN.pdf.

[2] Report of the Committee on Economic and Monetary Affairs (A5-0040/2004); rapporteur Giorgos Katiforis.

[3] CESR's technical advice to the European Commission on possible measures concerning credit rating agencies, CESR/05/1 39b, March 2005, available at: http://www.cesr-eu.org.

[4] Code of Conduct Fundamentals for Credit Rating Agencies, The Technical Committee of the International Organization of Securities Commissions, December 2004, see Annex on IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.

[5] White Paper on Financial Services Policy (2005-2010), COM(2005) 629 final.

2. CREDIT RATING AGENCIES

2.1 **Functioning of credit rating agencies**

Credit rating agencies issue opinions on the creditworthiness of a particular issuer or financial instrument. In other words, they assess the likelihood that an issuer will default either on its financial obligations generally (issuer rating) or on a particular debt or fixed income security (instrument rating).

These opinions - or ratings - are based on information relating to revenue stream and balance sheet (with particular focus on the debt) of the rated entity. Past financial performance is also considered. They only give an indication as to the situation at a given time and must therefore be periodically confirmed or revised to take account of recent economic or other developments. The credit ratings effectively categorise issuers into corresponding grades, depending on whether they are considered as more or less default-prone. Credit rating agencies employ comprehensive creditworthiness scales, with the critical border line running between the so-called investment grade (low-risk) and speculative grade (high-risk), reflecting the risks related to the security (i.e. the likelihood of default).

Ratings are usually requested - and paid for - by the issuers themselves. In these cases, they are based on both publicly available data and information which is not accessible to the public but which is voluntarily disclosed by the rated entity (e.g. by means of interviews with senior financial officials of the rated entity). However, credit rating agencies sometimes issue unsolicited ratings (i.e. ratings which have not been requested by an issuer). These are usually prepared without access to non-public information.

Although the provision of ratings is obviously their core activity, many credit rating agencies make use of their expertise in risk assessment to provide other financial services (e.g. investment advice) to issuers (either directly or through related entities).

2.2 **Impact on the financial markets**

Credit ratings carry considerable weight in financial markets. There are two basic reasons for this. First, although they are based on complex assessments they can be easily and instantly assimilated by investors regardless of their expertise and profile. Secondly, credit rating agencies enjoy a good reputation and are seen by market participants to be providing unbiased data analysis.

The importance of credit rating agencies in recent years can be observed in both business practice and regulatory requirements. On the one hand, the commercial success of most debt instrument issues largely depends on the rating granted. A rating has become a pre-requisite for seeking external financing in the securities markets (especially when issuers do not have an established presence on the debt markets).The credit rating of an issuer determines the interest rates that they will have to offer in order to obtain external financing. Moreover, credit ratings are increasingly used in contractual provisions regarding the termination of credit availability, acceleration of debt repayment or modification of other crediting conditions.

On the other hand, several jurisdictions now insist that certain types of investment products can only be sold if the issuer can demonstrate a certain grade of creditworthiness reflected in a rating issued by a recognised credit rating agency. Credit rating agencies are also increasingly involved in the assessment of the risks associated with assets held by financial institutions which are subject to capital adequacy requirements.

The role which credit rating agencies play in the markets is generally very positive for both investors and issuers. They provide investors with information which helps them to assess the risks related to a security. And they help to lower the costs of raising capital for issuers (or at least for those issuers who receive a favourable rating).

2.3 **Issues of concern**

The Resolution of the European Parliament does not call into question the positive role that credit rating agencies can and generally do play. However, it identifies a number of issues of concern which require serious attention in order to ensure that all credit rating agencies exercise their functions responsibly at

all times ([6]).

Concern centres on the quality of credit ratings provided by credit rating agencies. Credit rating agencies must base their ratings on a diligent analysis of the available information and control continuously the integrity of their information sources. This means that credit ratings must be regularly updated, if necessary. Credit rating agencies must also be more open about the way in which their ratings are arrived at. In addition, it is important that credit rating agencies are independent and entirely objective in their approach. The position of credit rating agencies must not be compromised by the relationships which they have with issuers. There are also concerns relating to the access which credit rating agencies have to inside information of issuers. It is important that credit rating agencies are prevented from using this information for other activities. Finally, the European Parliament expressed concern about the degree of concentration in the ratings industry and its possible anti-competitive effects.

3. RELEVANT REGULATION

The issues relating to credit rating agencies are serious and must be tackled. Both the new EU-level legislative framework and the IOSCO Code seek to do this. The EU legislation applies only to credit rating agencies operating in the EU. The Code, on the other hand, is expected to be applied by credit rating agencies in all jurisdictions where they operate. In terms of content, the Code complements the EU legislation. While the Directives are legally binding, the Code works on a 'comply or explain' basis - i.e. credit rating agencies are expected to incorporate all the provisions of the IOSCO Code into their own internal Codes of Conduct. Where they choose not to do this, they must explain how their Code nevertheless gives effect to the provisions of the IOSCO Code.

3.1 **EU legislation**

The aim of the FSAP was to create open, integrated and efficient financial markets in the EU - where competitive forces maximise investors' returns - but where investors are not subject to excessive risk. It therefore sought to minimise the regulatory burden on firms while at the same time maintaining an

[6] See footnote 1.

effective level of regulatory control and a high level of investor protection.

There are three FSAP Directives which are relevant to credit rating agencies. The most important is the **Market Abuse Directive ('MAD')** which - together with its implementing Regulation and Directives ([7]) tackles the issue of insider dealing and market manipulation (market abuse) in order to ensure the integrity of Community financial markets and to enhance investor confidence in those markets. Insider dealing and market manipulation prevent full market transparency, which is important for trading for all economic actors in integrated financial markets. In the field of conflicts of interest, fair presentation of investment recommendations and the access to inside information, the provisions of the Market Abuse Directives constitute a comprehensive legal framework for credit rating agencies while, at the same time, acknowledging their specific role and the differences between credit ratings and investment recommendations.

In order to prevent insider dealing and market manipulation, the Directive 2003/125/EC addresses the fair presentation of investment recommendations and the disclosure of conflicts of interest. For the purposes of the said Directive, credit ratings do not constitute a recommendation but they are regarded as opinions on the creditworthiness of a particular issuer or financial instrument. Nevertheless, it is stipulated that credit rating agencies should consider adopting internal policies and procedures designed to ensure that credit ratings published by them are fairly presented. Moreover, it is stated that a credit rating agency discloses any significant interests or conflicts of interest concerning the financial instruments or the issuers to which their credit ratings relate ([8]). Additionally, it follows from the Directive 2003/6/EC that, in case a credit rating agency knew, or ought to have known, that the credit rating was false or misleading, the prohibition to disseminate false or misleading information, constituting market manipulation, may apply to credit ratings ([9]). Considering these provisions, it is clear that credit rating agencies need to implement internal procedures and policies to ensure objective, independent and accurate credit ratings which will benefit investor confidence. It is of major importance for the Commission that credit rating agencies will effectively enforce their procedures to ensure high quality of credit ratings.

With respect to the legal treatment of credit rating agencies' access to inside information, the Directive 200 3/6/EC prohibits any person possessing inside information from using that information by acquiring or disposing of financial instruments to which that information relates. Inside information is defined as information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments and which, if it were made public, would be likely to have a significant effect on the price of those financial instruments or on the price of related derivative financial instruments ([10]). As a rule, an issuer must disclose inside information as

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[7] Directive 2003/6/EC of 28/01/03 (OJ 2003 L 96/16); Commission Directive 2003/124/EC of 22/12/03 (OJ 2003 L 339/70); Commission Directive 2003/125/EC of 22/12/03 (OJ 2003 L 339/73); Commission Directive 2004/72/EC of 29/04/04 (OJ 2003 L 162/70) and Commission Regulation (EC) No 2273/2003 of 22/12/03 (OJ 2003 L 336/33).

[8] See Article 1(8) and recital 10 of Directive 2003/125/EC.

[9] Article 1(2) under c stipulates that *'market manipulation shall mean: dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumours and false or misleading news, where the person knew, or ought to have known, that the information was false or misleading.(...)'*

[10] Article 1(1) and 2(1) of Directive 2003/6/EC.

As a result, a credit rating agency or an employee who has access to inside information of any sort is prohibited from any trading using inside information. Moreover, disclosure of this inside information to anyone else except in the normal course of employment, profession or duties is not allowed. In this respect, Article 6(3), third subparagraph of Directive 200 3/6/EC states that issuers, or persons acting on their behalf or for their account, draw up a list of persons working for them who have access to inside information. This provision allows

soon as possible. Consequently, there will be few circumstances in which an issuer can legitimately be in possession of inside information that has not already been disclosed to the market. If an issuer decides to allow a credit rating agency access to inside information, the credit rating agency would owe a duty of confidentiality as required by Article 6(3) of Directive 200 3/6/EC.

In addition to having access to inside information of the issuer, it is possible that a credit rating itself constitutes inside information, in particular when the credit rating agency has access to non-public information of the issuer. This implies that using the unpublished rating for trading or disclosing this information to anyone else, except in the normal course of employment, profession or duties, is prohibited. However, a credit rating agency communicating an imminent rating publication to the issuer on a confidential basis for the purpose of checking the accuracy of the information it is based on would be allowed.

The Commission believes that the provisions of the Market Abuse Directives provide a comprehensive set of rules for the activities of credit rating agencies in the area of market abuse concerns. The specific role of credit rating agencies in the financial markets requires diligent application of these provisions. Consequently, the Commission will monitor actively the implementation and enforcement of these provisions in the Market Abuse Directives in relation to credit rating agencies.

The second item of EU legislation which is relevant to credit rating agencies is the **Capital Requirements Directive ('CRD')** which introduces a new capital requirements framework for banks and investment firms ([11]). The CRD is based on the new international capital requirements framework agreed by the Basel Committee on Banking Supervision ('Basel II') in 2004.

The CRD provides for the use of external credit assessments in the determination of risk weights (and consequential capital requirements) applied to a bank or investment firm's exposures. Only the use of assessments provided by recognised External Credit Assessment Institutions ('ECAIs'), mainly credit rating agencies, will be acceptable to the competent authorities. A recognition mechanism is also outlined in the Directive.

The CRD sets out a number of requirements which ECAIs should meet before the competent authority grant them recognition. For example, their ratings must be objectively and independently assigned and reviewed on an ongoing basis. In addition, their rating procedures should be sufficiently transparent. In addition, the competent authorities should assess whether individual credit assessments are recognised in the market as credible and reliable by the users of such credit assessments and accessible at equivalent terms to all interested parties.

Building on the CRD, the Committee of European Banking Supervisors ('CEBS') is working to promote convergence of the recognition processes of ECAIs across the EU by defining a common understanding on the criteria necessary to implement the recognition requirements laid down in the

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Member States to require credit rating agencies to draw up lists of insiders. These lists must regularly be updated and transmitted to the competent authority whenever the latter requests it.

[11] Re-casting Directive 2000/12/EC of the European Parliament and of the Council of March 20, 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of March 15,1993 on the capital adequacy of investment firms and credit institutions.

CRD ([12]).

Clearly, the CRD does not constitute a form of regulation of credit rating agencies on how to do business but focuses predominantly on the weighting of capital requirements. Consequently, the recognition process of ECAIs does not address the broader conduct of business issues concerning credit rating agencies in general. Moreover, credit rating agencies may choose not to become ECAIs under the CRD and therefore the CRD may not cover the entire population of credit rating agencies. However, the objectives and effects of the ECAI recognition system cannot be seen separately from the aims of other legislation and supervisory standards applicable to credit rating agencies since the CRD affirms the meaningful function of credit rating agencies. To this end, the Commission will closely monitor developments with regard to the recognition of ECAIs and assess whether credit rating agencies perform their important role adequately under the CRD. Hence, competent authorities should ensure that the effects of recognition are shared with all stakeholders in order to assess whether the ECAI recognition criteria could be used in the future for conduct of business regulation of credit rating agencies, if this appears to be necessary.

The final piece of relevant legislation is the **Markets in Financial Instruments Directive** ('MiFID') ([13]). MiFID and its future implementing measures are not applicable to the rating process of credit rating agencies in the case where the rating process itself does not involve the firm undertaking investment services and activities as defined in the MiFID. In other words, the issuing of a credit rating will normally not result in the credit rating agency also providing 'investment advice' within the meaning of Annex I to the MiFID. But credit rating agencies should be aware of the precise limits of this activity in order to continue to operate outside MiFID regulation. However, credit rating agencies that also provide investment services and activities on a professional basis may require authorisation. In such cases, the MiFID provisions regarding conduct of business and organisational requirements will apply to the firm and its undertaking of investment services and activities. Where, for example, a credit rating agency provides investment services (such as investment advice) to clients that fall under the MiFID, the provisions on conflicts of interest will apply to protect the interest of those who receive these services. The provisions on conflicts of interest may require an appropriate degree of separation of investment services from the credit rating process so that ancillary services may not interfere with the quality and objectivity of credit ratings ([14]).

This comprehensive legal framework is now being put in place by the Member States. All Directives must be correctly implemented. Consequently, the transposition of the Directives is actively monitored by the Commission. It may initiate infringement procedures on the grounds of incorrect or non-transposition of the Directives, where necessary.

Another area of Community law which is potentially important for credit rating agencies is **competition law.** The Commission does not share the European Parliament's concerns about the degree of concentration in the ratings industry. There is no indication of any anti-competitive practices in this industry but any evidence to the contrary will be examined thoroughly. The Commission does not therefore see the need for action in this area at the moment. Moreover, one could conceive that in this particular industry, excessive market fragmentation could have adverse consequences (i.e. credit rating agencies may face undue pressure to issue favourable ratings in order to attract clients).

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[12] CEBS Consultation paper on the recognition of External Credit Assessment Institutions, June, 292005, available at http://www.cebs.org/pdfs/CP07.pdf

[13] Directive 2004/39/EC of 21/04/04 (OJ 2004 L 145/1).

[14] See Articles 13(3), 13(10) and 18 of the MiFID.

3.2 **The IOSCO Code**

In September 2003, IOSCO published its Principles Regarding the Activities of Credit Rating Agencies ('IOSCO Principles') ([15]), setting high-level objectives for credit rating agencies, securities regulators, issuers and other market participants to improve investor protection and market fairness, efficiency and transparency and to reduce systemic risk. In response to comments on these principles, IOSCO developed the IOSCO Code of Conduct Fundamentals for credit rating agencies (see Annex).

Reflecting the global nature of the market for credit rating agencies, the IOSCO Code is meant to be applied by rating agencies of all sizes and business models and in every jurisdiction. The Commission notes that the IOSCO Code has not been implemented into the national law of Member Sates. However, credit rating agencies are expected to give full effect to the provisions of the IOSCO Code - as long as these provisions are consistent with the EU Directives. This requires that credit rating agencies incorporate the IOSCO Standards in their procedures. Recent market developments show that several credit rating agencies have set up their own Codes of Conduct along the lines of the IOSCO Code which proves that the latter provides a useful set of standards for self-regulation of the credit rating industry.

It is very important that credit rating agencies not only incorporate the IOSCO Code in their own Code of Conduct but fully comply with the IOSCO Code by enforcing their Code of Conduct in daily practice. Credit rating agencies need to inform regularly in the coming years all stakeholders about their compliance with their Codes of Conduct. To this end, the Commission recommends to analyse the effects of the IOSCO Code on a regular basis.

4. **CONCLUSION**

Following the request by the European Parliament, the Commission has considered very carefully whether or not fresh legislative proposals are required to regulate the activities of credit rating agencies.

Its conclusion is that at present no new legislative initiatives are needed. One of the central principles of 'Better Regulation' is that legislative solutions should be applied only where they are strictly necessary for the achievement of public policy objectives. The Commission believes that the case for new legislation in this area remains unproven.

There are already three new financial services Directives which cover credit rating agencies. The Commission is confident that these Directives - when combined with self regulation by the credit rating agencies themselves on the basis of the newly adopted IOSCO Code - will provide an answer to all the major issues of concern raised by the European Parliament.

In its advice to the Commission, CESR also indicated that the right balance between legislation and self-regulation had been struck and that no further regulatory initiatives were needed for the time being.

However, the Commission is continuing to monitor developments in this area very carefully. It is clear that the new arrangements will only produce the desired results if credit rating agencies take the task of regulating themselves sufficiently seriously. They must be scrupulous in implementing the provisions of the IOSCO Code. And they must be open and transparent about the way in which they

[15] IOSCO's Principles Regarding the Activities of Credit Rating Agencies, available at www.iosco.org/IOSCOPD151.

are doing it.

It is encouraging that many credit rating agencies have established their own Codes of Conduct based on the IOSCO Code. But establishing these Codes in itself is not enough; they must also be implemented in practice on a day to day basis. The Commission intends to ask CESR to monitor compliance with the IOSCO Code and to report back to it on an annual basis. It will also consider how best to gauge the opinions of market participants, especially those purchasing complex financial instruments. This might include the setting up of an informal expert group. The ratings industry should be aware that the Commission may have to take legislative action if it becomes clear that compliance with EU rules or the Code is unsatisfactory and damaging EU capital markets.

The Commission will also consider introducing legislative proposals if new circumstances arise - including serious problems of market failure.

Finally, the Commission intends to monitor the global development of the rating business. If there are significant changes in the way credit rating agencies are regulated in other parts of the world, it may be necessary for the Commission to re-evaluate its approach.

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