A Comparative Study of Credit Rating Agency between the United States, European Union and China

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Abstract

The credit rating agencies (hereafter CRAs) plays a significant role in the financial market but they were criticized for failing to accurately reflect the default risks of bonds, especially in structured finance, which exacerbated the global financial crisis of 2007–8, or even resulted in the financial disruptions throughout the entire financial market in two respects: the over-reliance on credit ratings and the low rating quality. Against this background, this thesis is designed to identify the issues that cause such big rating failures and analyse the effectiveness of the existing regulations against such issues. More importantly, having illustrated the issues and regulations, this thesis puts forward some suggestions to the current regulatory frameworks.

This thesis analyses the issues form both external and internal perspectives. From an external perspective, the market and regulatory over-reliance on the credit ratings strengthen the interconnections among the financial institutions and intermediaries in the financial market, which exacerbates the liquidity risk and systemic risk stemming from the rating downgrades, especially during the financial crisis. From an internal perspective, three issues that affect the accuracy of credit ratings and the independency of CRAs include the conflict of interest, the oligopolies market structure and the civil liability for CRAs. Firstly, the conflict of interest provides incentives for CRAs to provide inflated rating services. Secondly, when the oligopolistic members are aware of their dominant market status, they lack motivations to update rating models and methodologies. Thirdly, it analyses whether or not civil liability is an effective approach to deter CRAs from their low rating quality. This thesis adopts a comparative approach between the European Union, United States and China. In order to provide a better understanding for the different problems with respect to the issues mentioned above and the different jurisdictions in these three regions, it first introduces the respective evolution of CRAs in these three areas respectively. It then examines the effectiveness of their various regulatory approaches to each issue as mentioned above.

Xiayang Chen, 30 December 2020

Keywords: Credit Rating Agencies, Over-Reliance, Conflicts of Interest, Oligopoly, Civil Liability, Financial Regulation

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Author's Declaration

I declare that, except where explicit reference is made to the contribution of others, this dissertation is the result of my own work and has not been submitted for any other degree at the University of Glasgow or any other institution.

Signature:

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Date: 30 December 2020

Abbreviations

ABS	Asset-backed securities
CCPG	Chinese Central People's Government
CCXI	China Cheng Xin International Credit Rating Co. Ltd
CCXR	China Cheng Xin Securities Rating Co., Ltd
CDO	Collateralized Debt Obligation
CDS	Credit Default Swap
CESR	Committee of European Securities Regulators
CIRC	China Insurance Regulatory Commission
CRARA	Credit Rating Agency Reform Act of 2006
CRAs	Credit Rating Agencies
CSRC	China Securities Regulatory Commission
EBA	European Banking Authority
EC	European Commission
ESMA	European Securities and Markets Authority
EU	European Union
HHI	Herfindahl-Hirschman Index
MNPI	Material non-public information MBS Mortgage-backed security
NAFMI	National Association of Financial Market Investors
NRSRO	Nationally Recognized Statistical Rating Organization
OCR	Office of Credit Ratings
OTC	Over-the-Counter
PBOC	People's Bank of China
PSLRA	Private Securities Litigation Reform Act 1995
RMBs	Residential mortgage-backed securities
S&P's	Standard & Poor's
SAC	Securities Association of China
SB&IS	Shanghai Brilliance Credit Rating & Investors Service Co. Ltd
SEC	Securities and Exchange Commission
SFC	Securities and Futures Commission
SOEs	State-owned enterprises
UK	United Kingdom
US	United States

Chapter 1: Introduction

Credit ratings are published by credit rating agencies (hereafter 'CRAs') and used by investors to assess the default rates of bonds. Credit ratings are utilized to reduce the information asymmetry between investors and bonds so that investors can make investment decisions. However, during the global financial crisis of 2007–8 (also hereafter 'global financial crisis' or 'financial crisis'), CRAs were criticized for failing to accurately reflect the default risks of bonds, especially in structured finance, which exacerbated the financial crisis, or even resulted in the financial disruptions throughout the entire financial market in two respects: the over-reliance on credit ratings and the low rating quality. Against this background, this thesis is mainly designed to answer the following questions: (i) What are the main issues caused such a big rating failure during the financial crisis? (ii) Are there regulations in place to cope with these issues? Do these regulations achieve their goals? If so, how; if not, why? (iii) To what extent do the regulatory approaches to the problems differ in the European Union, United States and China? What are the possible reform proposals for improving the existing regulations?

In order to answer the first research question, four issues that led to the big rating failure are analysed in this thesis, (i) the over-reliance on credit ratings, (ii) the conflict of interest, (iii) the oligopolistic market structure in the rating industry and (iv) the civil liability for CRAs, which are discussed in Chapters 3 to 6 respectively. From an external perspective, markets and regulators overly rely on credit ratings, which directly strengthens the interconnections among the financial institutions and intermediaries in the financial market, and further exacerbates the liquidity risk and systemic risk stemming from the rating downgrades, especially during the financial crisis. Chapter 3 aims to explain why the over-reliance on credit ratings does have such a big influence on the financial market. From an internal perspective, inaccuracy of credit ratings constitutes another reason for the rating failure during the financial crisis. In this thesis, the issues that affect the accuracy of credit ratings and the independence of CRAs are conflicts of interest, oligopoly and the civil liability for CRAs. Chapter 4 aims to address what the conflicts of interest are with which CRAs are faced, and how they are motivated by these conflicts to provide numerous rating services regardless of their rating quality. Chapter 5 focuses on the negative influence of the oligopolistic market in the rating industry on the rating quality. Chapter 6 aims to examine whether or not the current civil liability regimes for CRAs in the European Union, United Sates and China effectively deter CRAs from issuing inaccurate ratings that, to some extent, mislead investors into making investment decisions. In short, the four issues in this thesis are designed to explain the external and internal reasons for rating failure in the financial crisis.

In order to answer the second research question, in each chapter (Chapters 3 to 6), the existing regulations respectively targeted at the issues in the European Union, United States and China as mentioned above will be introduced first. In addition, having demonstrated the effectiveness and implementation of these regulations, the advantages and challenges of these regulations will also be discussed. In terms of the third research question, considering the different challenges of the existing regulations in each jurisdiction, Chapters 3 to 6 analyse the regulatory approaches and the possible solutions. Furthermore, this thesis attempts to provide some reform proposals to further improve the current regulatory frameworks. To better understand the various problems with respect to the issues listed above and the different jurisdictions in the European Union, United States and China, Chapter 2 introduces the evolution of CRAs and the relevant regulatory systems in the three regions, and different impacts of rating failures during the financial crisis on these areas. This chapter serves to provide a wider social context in which, and factors that resulted in, the emergence and development of CRAs. More importantly, from a historical perspective, this also explains why these areas have the different regulatory approaches to each of the same issues mentioned.

Throughout the thesis, a comparative approach between the European Union, United States and China is adopted. Even though the CRAs in the three regions are different in terms of economic environment, legislative system and development of the credit rating industry, they are faced with the same issues as mentioned above. This constitutes the basis of the comparative analysis in the thesis. In terms of the first research question, it demonstrates how specific problems relating to CRA issues in the three areas are different. While discussing the latter two questions, it discusses what the different challenges faced by the three areas are, and why the regulatory approaches regarding these challenges differ in each region. In addition, Chapter 2 adopts a retrospective study to take stock of the evolution of CRAs in the three areas. Apart from that, for the US civil liability regime of CRAs, in Chapter 6, the case law is concentrated on more so as to better address each obstacle against establishing civil liability for CRAs on a case-by-case basis.

Chapter 2 aims to address why the CRA issues faced by the European Union, United States and China are different, as well as why the three areas carry out different regulatory strategies and countermeasures for the same issues, as set out in the chapters that follow. A CRA could be regarded as a financial intermediary, and the bond market is the underlying market. The chapter first addresses the impact of bond market evolution on the development of CRAs. Next, it discusses the relationships between the evolution of CRAs and the development of their underlying bond markets. Chapter 2 also compares the various impacts of the financial crisis on the European Union, United States and China. In addition, it introduces the regulatory regimes in the three regions, which lays a foundation for better analysing the influences, which vary in degree, on the subsequent regulatory approaches related to CRAs.

Chapter 3 tries to address why the credit ratings are so important for regulators and financial institutions, and how CRAs have such a huge influence on the financial system. It first addresses the widespread use of credit ratings in legislation, regulation and supervisory policies. Then, it discusses a series of influences caused by rating downgrades and how the over-reliance exacerbated these negative impacts on the financial market. To cope with these negative impacts, the European Union, United States and China carry out various regulatory approaches against over-reliance. It then analyses to what extent these regulatory approaches and their implementations are effective.

Chapter 4 aims to answer the two questions: (i) how do the conflicts of interest within the credit rating industry affect the rating quality; (ii) how can we improve the rating quality in this respect? Conflicts of interest in relation to credit rating arise in a situation where an agency or agency employees have the necessary incentives to compromise their integrity for personal gain during a rating activity.[1] Such conflicts create various incentives for CRAs and, consequently, they are more likely to integrate a laissez-faire attitude which finds in favour of their customers, especially under the issuer-pays model. At first, the chapter introduces the main conflicts of interest at the individual level and the countermeasures against these conflicts in the European Union, United States and China respectively, ranging from corporate governance to regulations. Next, conflicts at the agency level include rating shopping and ancillary service, which are more difficult to manage. While discussing the existing regulations and internal controls against these conflicts in the European Union, United States and China, the thesis addresses the challenges in coping with the ancillary services and rating shopping. In order to better manage the conflicts of interests, some researchers provide reform proposals associated with the business model. Having demonstrated the advantages and challenges of these reform proposals, a proposal with

[1] Cristian Marzavan and Tănase Stamule, 'Conflicts of Interest's Management within Credit Rating Agencies' (2009) 4(3) Management & Marketing 111.

respect to the prohibition on structured finance will be discussed, based on the observation that credit ratings related to structured financial products seem more obviously inaccurate compared to the rating in corporate bonds.

Chapter 5 attempts to address the negative impacts of oligopoly on the CRA industry and regulation. The *credit rating market* could be defined as an oligopoly of the 'big three'[2]. In such a market, the big three lack incentives to improve the accuracy of credit ratings, and the oligopoly becomes a regulatory hurdle to making CRAs behave well. To deal with oligopoly, one of the common regulatory strategies is to enhance competition. The chapter then analyses the effectiveness of the relevant regulations in the European Union, United States and China, and puts forward a reform proposal to make the CRAs behave better.

Chapter 6 mainly analyses whether or not civil liability regime is an effective approach to deter CRAs from their low rating quality. This chapter introduces the civil liability regimes for CRAs in the European Union, United States and China, and addresses the main obstacles in establishing civil liability for the respective CRAs in these three areas. In addition, it also aims to compare the effectiveness of public enforcement, such as reports and monetary penalty, and private actions. As demonstrated in Chapters 4 and 5, structured finance provides sufficient motivation for CRAs to provide inflated ratings and the oligopoly further weakens the reputational cost for CRAs when they provide low-quality rating services. In order to create a new incentive for CRAs that motivate them to improve or deter them from improving their rating quality, civil liability for CRAs became a new regulatory focus post the financial crisis. On the one hand, many market participants suffered numerous losses for inflated or even inaccurate ratings during the financial crisis, but few investors with contractual relationships could claim damages against CRAs. This gave rise to a discussion as to whether or not it is necessary to establish civil liability for CRAs as a gatekeeper or an expert. On the other hand, following the financial crisis, the regulators aimed to rebuild market confidence in credit ratings by integrating a civil liability regime for CRAs into the regulatory framework, based on the principle that civil liability can be regarded as a deterrent for the inaccurate ratings.

The aim of this thesis lies in exploring the rationales for, and weaknesses in, the current regulations for CRAs in the European Union, United States and China from a comparative

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[2] The 'big three' are Standard & Poor's (hereafter 'S&P'), Moody's Investment Service (hereafter 'Moody's'), and the Fitch Ratings (hereafter 'Fitch').

approach, and putting forward some viable reform proposals for the existing regulatory frameworks in order to further improve the accuracy of credit ratings.

Chapter 2: The Evolution and Regulatory Regimes of Credit Rating Agencies

2.1 Introduction

To better understand that the demand for the amelioration of information asymmetry created CRAs, it must first be explained what creates the information asymmetry. There are two basic participants in the financial market, namely (i) a lender and (ii) a borrower.[1] The optimal circumstance is that a lender lends surplus funds to an investment borrower who has a shortage of funds, and both lender and borrower will enjoy the returns, provided that flow of funds can be transferred efficiently from lender to borrower.[2] However, the borrower has more business information about the borrowing firm than the lender and the borrower does not disclose the some of the relevant information on purpose so as to gain an investment from the lender.[3] This gives a rise to information asymmetry. Bringing the scope of analysis back to the United States, at the beginning of the twentieth century, faced with a large number of choices in the corporate bond market, investors (lenders) needed urgently to break the information asymmetry, and the market needed an intermediary to ensure the smooth flows of funds between lenders and borrowers. As a result, CRAs fulfilled the role.[4]

CRAs can be generally defined as companies that offer professional assessment regarding the credit capacity of the debtor.[5] That assessment, namely credit rating, is 'an opinion regarding of the creditworthiness of an entity, a credit commitment, a debt or debt-like security or issuer of such obligations, expressed using an established and defined ranking system…credit ratings are not recommendations to purchase, sell or hold any security'.[6] As Kronwald stated, credit rating is 'an evaluation of the credit risk of a prospective debtor', which is used to not only assess debtors' ability to pay back the debt, but also predict probability of the debtor defaulting.[7] High rating generally means less risk of default by the

[1] Frederic S. Mishkin and Stanley G. Eakins, *Financial Markets and Institutions* (Eighth global, Pearson 2016) 36.
[2] Nan S. Ellis, Lisa M. Fairchild and Frank D'Souza, 'Conflicts of Interest in the Credit Rating Industry after Dodd-Frank: Continued Business as Usual' (2012) 7(1) Virginia Law& Business Review 4.
[3] ibid.
[4] ibid 5.
[5] Allana M. Grinshteyn, 'Horseshoes and Hand Grenades: The Dodd-Frank Act's (Almost) Attack On Credit Rating Agencies' (2011) 39(4) Hofstra Law Review 937, 950.
[6] IOSCO, 'Code of Conduct Fundamentals for Credit Rating Agencies' (2008), 4 <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf> accessed 10 October 2020.
[7] Christian Kronwald, *Credit Rating and the Impact on Capital Structure* (Norderstedt, Germany: Druck und Bingdung 2010) 20.

debtor.[8] Besides, as Lupica stated, credit rating, as a forecast made by CRAs, reflects the creditworthiness of the issuers and the quality of the securities they issue.[9]

A brief glance at the history of credit ratings will be helpful to analyse the problems in CRAs. In the United States, the credit rating industry has evolved over more than one hundred years. There were main three stages. In the first stage, a comparatively mature corporate bond market was the basis of CRAs. Later, doubts regarding the accuracy of the credit ratings limited the further development of CRAs. In the second stage, the regulatory use of credit ratings created the second peak in the credit rating industry. However, at the same time, this leads to an over-reliance on the Nationally Recognized Statistics Rating Organizations (hereafter 'NRSROs') in the future. In the third stage, the boom in structured finance brought CRAs into the public discussion because overly high credit ratings are deemed to have triggered the financial crisis. The EU sovereign crisis that followed also exposed the huge potential influence of CRAs in financial stability and the lack of internal rating agencies in the European Union. In China, the bond markets are divided and regulated by different regulators. Therefore, the question arises as to how multi-regulators supervision system further does have an influence on CRAs.

This chapter aims to analyse the roots that drive CRAs, such as the prosperity of the bond market and regulatory certificates. The bond market is the underlying market of the rating industry, and thus the different situations in the United States, European Union and China are all discussed from the angle of bond market. Furthermore, given that the credit rating industry originated in the United States, the United States has a comparatively complete evolution of rating agencies and more experiences to cope with various issues. However, the conflicts in respective areas during the recent economic crisis are exposed to various characteristics of the United States, European Union and China. This is therefore an attempt to address the diversity in the three jurisdictions that cause the different problems.

2.2 The Emergence of Credit Rating Agencies

The expanding corporate bond market was the prerequisite for the emergence of the CRA industry in the United States. The boom of corporate bonds created a huge demand for

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[8] Lois R. Lupica, 'Credit Rating Agencies, Structured Securities, and the Way Out of the Abyss' (2008) 28 Review of Banking and Financial Law 639, 639-40.
[9] ibid.

lenders (investors) to ameliorate the information asymmetry between borrowers and lenders. Objectively, to meet this demand, CRAs emerged.

The development of the US railroads in the twentieth century contributed to the boom in corporate bonds. Financial markets functioned well for several centuries prior to CRAs, which was the case because most investments in the securities market focused on sovereign bonds. It is generally believed that governments are capable of repaying their debts and sovereign bonds are more likely to be invested. With the private sector and corporate bonds developing rapidly in the nineteenth and twentieth centuries, the situation in the United States started changing in the twentieth century.[10] Since the early nineteenth century, with the increasing capital need to build railroads in the United States, corporations showed a mushroom-shaped growth. Most US railroads were organized and established as private corporations, with some governmental assistance.[11] After 1850, railroad corporations gradually expanded into undeveloped regions where a few banks and investors financed them. To cope with the funding problem, corporate bonds became an advisable way to raise money and the corporate bond market thus further enlarged, which was regarded as a US financial innovation. Until the nineteenth century, the US corporate bond market was larger than that of any other country, such as the United Kingdom and France.[12] In fact, with the booms in railroad bonds, a large amount of corporate bonds appeared in the United States. Between 1900 and 1943, the total par value of straight corporate bonds was USD 71.5 billion[13], including bonds offered by railroad, public utility, and industrial corporations and held by the investing public.[14]

As corporate bonds expanded in twentieth century, the information asymmetry between bonds issuers and investors further widened in three respects. First, at one point the investment choices were massively broadened by the boom of corporate bonds. Profit is the primary driving force in financial markets. A flourishing corporate bond market provides high-yield investment opportunities for investors. Secondly, corporate bonds are different from treasury bonds and any other kind of government bonds, especially when it comes to

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[10] Richard Sylla, 'A Historical Primer on the Business of Credit Rating' in R. M Levich, G. Majnoni and C. M. Reinhart (eds), *Ratings, Rating Agencies and the Global Financial System* (Springer, Boston, MA 2002) 24.
[11] ibid.
[12] Raymond W. Goldsmith, 'Comparative National Balance Sheets: A Study of Twenty Countries, 1688–1978' 94 (6) The Journal of Political Economy <http://www.jstor.org/stable/1833104> accessed 10 March 2019.
[13] USD 1 in 1900 is equivalent in purchasing power to USD 30.05 in 2018; USD 1 in 1943 is equivalent in purchasing power to USD 14.59 in 2018. See CPI inflation Calculator, 'Value of $1 from 1943 to 2018' <https://www.in2013dollars.com/1943-dollars-in-2018?amount=1> accessed 31 October 2018.
[14] W. Braddock Hickman, 'Corporate Bond Quality and Investor Experience' in W. Braddock Hickman (ed), *Corporate Bond Quality and Investor Experience* (Princeton University Press 1958) 7.

credit risk. Governments generally have good creditworthiness and investors are thus hardly concerned about bond defaults. However, in terms of corporate bonds, investors take all measures to reduce potential risks. When the first and second points are put together, the boom in corporate bonds rather than any other government bonds fundamentally creates the demand for ameliorating information asymmetry for investors.

Thirdly, the difficulty that common investors experienced in acquiring relevant business information from issuers was exactly the reason why the CRA emerged at that time. Faced with numerus corporate bonds, investors did not have sufficient time to investigate and distinguish between every bond. Besides, expanding the bond market in geographical scope made collecting business information more difficult. In the initial stage of business, when the scope of business was small, most transactions happened among people who overlapped in social networks. At that time, investors tended to lend money to those with whom they were familiar or who provided letters of recommendation; in other words, the extent of information asymmetry was not severe. There was thus no strong need to fulfil the information gap between investors and investees. However, since the second half of the nineteenth century in the United States, corporate bonds, to a large extent, financed the railroads, both in the domestic and international bond market.[15] As a result, faced with larger scopes of business and increasing corporate bonds, investors had pressing needs to reduce the information asymmetry so that they could make more informed investment decisions.

CRAs bridged the gap of increasing information asymmetry between the investors and bonds issuers. Before the advent of CRAs, credit reporting agencies and the financial press had already attempted to gather business information and provide professional reports on the creditworthiness of US firms for a long time.[16] Later in order to satisfy the continual demand for amelioration of information asymmetry, CRAs emerged. Faced with the massive choices in the railroad bond market, as John Moody thought, investors were willing to pay for the service that synthesized the mass of information into an easily digestible format.[17] In 1909, Moody's Investment Service (hereafter 'Moody's') was founded by John Moody as the first CRA that provided company appraisals for investors.[18] Moody's collected and synthesized the relevant financial information, which included assessment of the quality of a business's

[15] Richard Sylla (n 10).
[16] ibid.
[17] Frank Partnoy, 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers' [2006] Legal Studies Research Paper Series Research Paper 63.
[18] Erin M, Wessendorf, 'Regulating the Credit Rating Agencies' (2008) 3 Enterpreneurial Business Law Journal 155.

portfolio and corporate management, to create an estimate of risk for corporate debt and provided ratings for subscribers. In other words, the credit rating fulfilled the role of ameliorating information asymmetry through providing professional assistances for investors.

It should be noted here what contribute to the emergence of the credit rating industry in China? One of the reasonable explanations for this is that prior to the Chinese Economic Reform in 1978, this type of economy had been planned for many years. Even though since 1978 China has abandoned the plan, it still had some remaining effects during the 1980s, especially in the regulatory framework. The Chinese government was accustomed to designing and planning the tendencies in the market. The advantage was that some of the predicable problems could be avoided. In the context of the issue of enterprise bonds being permitted in 1987 in order to better regulate enterprise bonds, even the whole bond market, the regulation pertaining to CRAs was enacted. Consequently, many rating agencies were followed.

2.3 The Evolution of Credit Rating Agencies

2.3.1 Stock Crash of 1929 and the Securities Act of 1933

CRAs encountered the first challenge in 1929. During the Stock Market Crash of 1929, there were numerous bond defaults and investors doubted whether or not the credit ratings were valid or valuable. Admittedly, in a downturn of the stock market, the reliance on credit ratings is likely to be increased, because investors are inclined to select low-default bonds, namely bonds with a high credit rating. [19] However, the stock market crash of 1929 destroyed the confidence of investors regarding credit ratings. Prior to the stock crash, the major CRAs issued a large amount of ratings, most of which were overly high. By the end of the 1920s, there were approximately 6 000 bond issues in the US bond market, which amounted to USD 26 billion and a majority of those bonds were rated by CRAs.[20] As shown in Table 2.1, most of the ratings by the main CRAs were Category A in 1929. That triggered credit rating inflation in the 1930s. For instance, the bond of Chicago, Rock Island & Pacific Railroad was rated Category A by all the major agencies in 1929 but it was in default in 1934.[21]

[19] Thomas J. McGuire, 'Ratings in Regulation: A Petition to the Gorillas' (1995) Delivered to the SEC Fifth Annual International Institute for Securities Market Development 17.
[20] Frank Partnoy, 'The Siskel and Ebert of Financial Markets? Two Thumbs down for the Credit Rating Agencies' (1999) 77 Washington University Law Quarterly 619, 640.
[21] ibid 643.

Following on the heels of the stock market crash, was a wide range of downgrades of credit ratings. Besides, the hysteretic nature of credit ratings gradually realised that there was a lag between the time of the market prices and the time that the credit ratings revealed the negative information.[22] Therefore, investors began to lose confidence in the CRAs' ability to generate valuable information and were not as interested in purchasing credit ratings as before.[23]

Table 2.1: Distribution for issues by ratings, 15 July 1929[24]

Rating	Fitch	Moody	Poor	Standard
A (included A+ and A-)	291	259	267	275
B (included B+ and B-)	61	86	90	82
C+	3	0	0	4
D+	0	0	0	1
Unrated	8	18	6	1

As a tool to reduce the information asymmetry, why are CRAs so important? Because it was not compulsory to disclose information in the United States until 1933; in other words, credit rating could be regarded as an exclusive approach to disclose business information for lenders and investors before 1933. Under the Securities Act of 1933 (hereafter 'Securities Act'), all securities offered in the United States are required to be registered with the Securities and Exchange Commission (hereafter 'SEC') unless some securities qualify for exemption from the registration requirements. The registrants should provide essential facts, which include the following: '1. A description of the company's properties and business; 2. A description of the security to be offered for sale; 3. Information about the management of the company; 4. Financial statements certified by independent accountants.'[25] This registration aims to disclose important financial information so that investors can make informed decisions, but it does not guarantee the accuracy of information provided by companies.

Compared with the Securities Act focuses on disclosure of securities in the primary market, the Securities Exchange Act of 1934 (hereafter 'Exchange Act') further emphasizes

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[22] ibid 644.
[23] Aline Darbellay, *Regulating Credit Rating Agencies* (Edward Elgar Publishing Limited 2013) 22.
[24] Gilbert Harold, *Bond Ratings As An Investment Guide: An Appraisal of Their Effectiveness* (The Ronald Press Company 1938) 90.
[25] Investor Gov, SEC, 'Registration Under the Securities Act of 1933' <https://www.investor.gov/introduction-investing/investing-basics/glossary/registration-under-securities-act-1933> accessed 10 October 2019.

periodical reports in the secondary market. Under the Exchange Act, the SEC was created and empowered to regulate the securities transaction and companies that publicly traded securities and were registered with the SEC.[26] The Exchange Act also has some disclosure and periodical reporting requirements for these companies in the securities exchange and over-the-counter market.[27] Owing to these disclosure and periodical reporting requirements, the role of CRAs in reducing information asymmetry between issuers and investors was not unique during the 1930s, and it was doubtful whether CRAs were able to generate valuable information.[28] Admittedly, these disclosure regulations, to some extent, reduce information asymmetry. Nevertheless, that does not mean that the role of CRAs can be replaced. The more information is disclosed, the less time investors have to read every document and to make informed decisions.

The first time that credit rating started being used for regulatory purposes was to distinguish between investment-grade securities and speculative-grade securities. In the face of the banking crisis in March 1931 and following the Great Depression in 1936, the Office of the Comptroller of the Currency defined the term *investment securities* and required banks to invest exclusively in investment-grade bonds, which meant that bank holdings of publicly traded bonds had to be rated BBB or higher by at least one CRA.[29] Once securities are rated by investment grade, the issuer of bonds and borrowers are more likely to acquire capital from investors and lenders. The investment-grade rating means access to capital markets and extends the finance channel to issuers and borrowers.[30] Another example would be institutional investors who only regard those corporate bonds rated as investment-grade as appropriate investments.[31] Even though this rule aims to prevent future bank failure, it substantially introduced CRAs into the financial regulatory framework.

2.3.2 The 1970s: Nationally Recognized Statistical Rating Organizations (NRSROs) and Globalization

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[26] Section 4(a), Securities Exchange Act of 1934 (Public No. 291, 73D Congress, HR 9323). The Exchange Act has been amended many times. In this paragraph, *Exchange Act* means the original one.
[27] For example, section 13 provides detail periodical requirements for every registered issuer. ibid.
[28] Partnoy (n 20) 644.
[29] Section 5136, Banking Act of 1935 (Public No. 305, 74th Congress, HR 7616).
[30] Committee on Governmental Affairs Unites States Senate, 'Rating the Raters: Enron and the Credit Rating Agencies' (2002) one hundred seventh congress, second session 2 <https://www.gpo.gov/fdsys/pkg/CHRG-107shrg79888/pdf/CHRG-107shrg79888.pdf> accessed 20 April 2020.
[31] ibid.

The credit rating industry remained stagnant for decades.[32] At the start of the 1940s, the overall economy was stable, and defaults of corporate bonds were rare. The demand for credit ratings was thus not so high.[33] During the Vietnam War (01 November 1955 to 30 April 1975), with the rising volatility of bond prices, the demand for credit information increased but the CRAs remained small and lacked enough reputational capital in order to meet the demand.[34] Besides CRAs, banks also fulfil the function of credit analysis.[35] In general, credit analysis provided by commercial banks took place on the balance sheet for a loan while CRAs provided a credit rating service related to issuance of a marketable debt instrument. Since the later part of the 1960s, it was comparatively difficult for commercial banks to take deposits due to Regulation Q[36]. Pursuant to Regulation Q, the capability of banks regarding savings and loans was further restricted, which thus negatively affected commercial banks to make credit analysis.[37] As investors were unable to get enough credit analysis from banks, they turned to CRAs. Therefore, the demand for CRA increased fast.

During the 1970s, with the breakdown of the Bretton Woods System and the steel crisis, the United States entered into economic stagnation, namely the 1973–75 recession. Later, the Stock Crash of 1973–74, ranging from Europe to North America made the recession more evident. To enhance the stability of the financial market, the SEC began to regard CRAs as a regulatory tool. In 1973, the SEC first utilized the CRA in determining capital requirements and distinguishing the quality of assets.[38] The SEC promulgated approvals to a handful of CRAs as NRSROs.[39] According to the Net Capital Rule, if securities could be rated as investment grade, deductions could be less and to ensure the credibility of credit ratings, these credit ratings were required to be issued by at least two NRSROs.[40]

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[32] Frank Partnoy (n 17).
[33] Partnoy (n 20) 647.
[34] ibid 648.
[35] Ekins and Calabria (n 32) 6.
[36] Regulation Q was promulgated by the Federal Reserve Board in 1933 and set out capital requirements for banks. Capital Adequacy of Bank Holding Companies, Saving and Loan Holding Companies, and State Member Banks (Regulation Q) (12 CFR 217).
[37] Ekins and Calabria (n 32) 6-7.
[38] In 1973, SEC adopted a uniform net capital rule, as a part of Net Capital Rule for broker-dealers (Rule 15c3-1), so as to ensure 'that registered broker-dealers have adequate liquid assets to meet their obligations to their investors'. Under the Net Capital Rule, broker-dealers were required to 'deduct from net worth certain percentage of the market value of their proprietary securities', but SEC thought that the deduction could be less.
See SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets' (2003), 5 <https://www.sec.gov/news/studies/credratingreport0103.pdf> accessed 20 April 2020.
[39] Merely three rating agencies were approved by SEC as NRSROs, namely Moody, S&P and Fitch rating agencies. See Basel Committee on Banking Supervision (The Joint Forum), 'Stocktaking on the Use of Credit Ratings' 3-4 <https://www.bis.org/publ/joint22.pdf> accessed 1 January 2020.
[40] SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets' (2003), 5 <https://www.sec.gov/news/studies/credratingreport0103.pdf> accessed 20 April 2020.

Apart from that, NRSROs were associated with administrative regulations with respect to financial activities. For instance, in the late 1970s, credit ratings issued by NRSROs were applied by the US Department of Education to 'set standards of financial responsibility for institutions which want to engage in student financial assistance programs under Title IV of the Higher Education Act of 1965'. For another instance, with respect to section 3(a)(41) of the Exchange Act, 'mortgage-related security' is required to be 'rated in one of the two highest rating categories by at least one NRSRO'. Gradually, US administrations increasingly depended on NRSROs. With the regulations relying on NRSROs, more and more issuers actively seek credit rating service of NRSROs. As a result, NRSROs gradually became a 'regulatory licence' and this regulatory licence offers NRSROs a privilege in market.[41] Institutional investors invest such bonds that were rated by an NRSRO.[42]

Additionally, the continually enlarged bond market and the globalization further promoted the credit rating industry. From the 1970s to 1990s, CRAs expanded meteorically. As the globalisation spreads to the Europe, the European bond issuers were able to enter into the American bond market, providing that they had positive credit ratings. In other words, the globalisation enlarged the bond market in geographical scope and increased the businesses of credit ratings, which further promoted the credit rating industry. Owing to the increase in international capital flows after the breakdown of the Bretton Woods System, more companies issued bonds in both domestic and international securities markets. In 1975, 600 new bonds issues were rated, raising the number of outstanding rated corporate bonds to 5,500.[43] The expansion of the bond market in geographic scale further expanded employment. To cope with the increasing demand at the global level, CRAs employed more analysts and set up more branches.[44] In 1980, there were merely 30 professionals in Standards and Poor's (hereafter 'S&P'), while the numbers rose to 800 analysts and 1 200 staff in total in 1995. For example, the Moody's annual revenue in 1999 was USD 564 million, and the 90 per cent was derived from bond rating as well as 30 per cent from abroad.[45] A further example, in 1999, the scope of the rating business in S&P covered 60 countries with offices in 16 countries, and Fitch Ratings (hereafter 'Fitch') covered 75

[41] Partnoy (n 20) 623.
[42] Anno Stolper, 'Regulation of Credit Rating Agencies' (2009) 33(7) Journal of Banking & Finance 1266.
[43] Frank Partnoy, 'The Siskel and Ebert of Financial Markets? Two Thumbs down for the Credit Rating Agencies' (1999) 77 Washington University Law Quarterly 619, 649–50.
[44] Raquel García Alcubilla and Francisco Javier Ruiz del Pozo, *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (Oxford University Press 2012).
[45] Lawrence J. White, 'The Credit Rating Industry: An Industrial Organization Analysis' [2001] New York University, Law & Economics Research Paper Series, 6.

countries with offices in 23 countries.[46] In the same year, Moody's rated 20 000 US issuers and 1200 non-US issuers, and the worth of rated securities reached USD 5 trillion.[47] S&P rated a slighter fewer number of issuers in each category and the rated securities was worth about USD 2 trillion.[48] As a result, Moody's and S&P gradually dominated the global ratings markets. It should be noted that with the globalization, the US CRAs could easily enter into the EU market, because there was no market entry limit for ratings issued by a non-EU country until the financial crisis. By contrast, at that time, the Chinese bond market was not yet established, let alone the credit rating market.

2.3.3 Twenty-first Century: The Financial Crisis of the Global Financial Crisis of 2007–8 and the Euro Area Crisis

Over the past decades, although CRAs played a crucial role in financial markets and their ratings were incorporated into regulation in many countries, the credit rating industry was not regulated. Until the twenty-first century, the credit rating industry was faced with some rating failures. That led to a rethinking of the necessity and importance of regulation regarding CRAs. In 2001, the Enron Corporation, an American energy, commodities, and services company based in Houston, Texas, was downgraded to the speculative grade by the Moody's and S&P four days before it announced its insolvency.[49] That downgrading was regarded as a delay, and the public and investors expressed their frustration and wrath at this delay.[50] This event gave rise to doubt regarding the accuracy and reliability of credit ratings. Furthermore, CRAs were questioned as to whether or not they should take the responsibility of gatekeepers of the market. The Enron scandal raised the alarm that self-disciplined regulation of the credit rating industry was far from enough. According to the detailed report regarding Enron's finances by the Senate Committee on Governmental Affairs, the SEC and the private-sector regulator should strengthen the supervision of CRAs.[51] Later in 2006, the US Congress enacted the Credit Rating Agency Reform Act of 2006 (hereafter 'CRARA')[52], which aims to better monitor and regulate CRAs.[53]

[46] ibid.
[47] Richard House, 'Ratings Trouble' [1995] Institutional Investor 245-6.
[48] ibid 246.
[49] Committee on Governmental Affairs Unites States Senate (n 30) 3.
[50] Caitlin M. Mulligan, 'From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors' [2009] Boston College Law Review 1275, 1284.
[51] Committee on Governmental Affairs Unites States Senate (n 30) 40.
[52] Credit Rating Agency Reform Act of 2006 (Pub L No. 109–291, 120 Stat 1327).
[53] Caitlin M. Mulligan (n 50).

A more well-known event is the 2007 financial global economic crisis, which was also deemed as another rating failure.[54] The inflated and inaccurate credit rating was attributed, to a large extent, to aggravate this financial crisis. At the beginning of the 2007 global financial crisis, adjustable-rate mortgages encouraged more and more people to purchase housing, which increased the demand for purchases, though most people who purchased houses were actually unable to afford them. Based on the mortgages, there was an unprecedented boom in the United States real estate market. In order to get more cash and diversify credit risks held on the balance sheet, these mortgage assets were securitized by financial institutions and sold to investors.

With more and more rethinking of the 2007 financial markets, people gradually realized the significant role CRAs played in financial stability. CRAs during this financial crisis failed to accurately price the value of securities and reflect the inherent information in detail in the process of securitization. Given that so many investors and even financial institutions overly and even solely depend on credit ratings, especially when they select debt securities, credit ratings have a huge effect in financial markets. However, the following doubt persists: are they capable of providing valid and accurate ratings? In order to maintain financial stability, Dodd–Frank Wall Street Reform and Consumer Protection Act (hereafter 'Dodd–Frank Act') was enacted in 2010, which contains some reforms to better regulate the credit rating industry.[55]

At the EU level, when the financial crisis spread from the United States to the European Union, the euro area crisis followed. In 2012, S&P downgraded nine European sovereign debt ratings, such as France, Greece, Portugal and Cyprus, as well as posted negative outlooks of an additional fourteen European countries, while only German kept a AAA rating and was not affected.[56] These downgrades increased uncertainty among investors, especially soon after the shock of the financial crisis, and easily incurred the wrath of European countries. The reason behind the EU's anger for these rating downgrades is that rating agencies tend to employ a lax requirement when the market is good, but once the bubble bursts, immediately act more severely. [57] Apart from that, external CRAs were

[54] ibid 1287.
[55] Dodd–Frank Wall Street Reform and Consumer Protection Act 2010 (Public Law 111-203, 111th Congress).
[56] Christopher F. Baum, Dorothea Schäfer and Andreas Stephan, 'Credit Rating Agency Downgrades and the Eurozone Sovereign Debt Crises' (2016) 24 Journal of Financial Stability <https://linkinghub.elsevier.com/retrieve/pii/S1572308916300249> accessed 4 December 2020.
[57] Christian Scheinert, 'The Case for a European Public Credit Rating Agency' (European Parliamentary Research Service 2016) PE 589. 865

deemed to have overlooked the imbalance in public finance and the lack of sustainability of growth models during this European sovereign crisis.[58] In this regard, CRAs were blamed for not warning investors prior to the financial crisis but accelerating bubbles and causing further deterioration of the financial crisis.

In contrast, the sovereign rating downgrades in the eurozone had a worse effect than in other areas that had not adopted one common currency. In 2009, the Greek sovereign rating downgrade triggered a string of crises, from the Greek debt crisis to the whole eurozone crisis, affecting the entire Europe. This sovereign downgrade in Greece presented differently because Greece, as a part of the eurozone, had adopted the euro as the common currency and thus did not have the opportunity for increased trade after its currency devaluation. In general, once a sovereign rating downgrades, numerous investments, particularly foreign investments, will shift abroad, and the national currency will thus depreciate. That currency devaluation will decrease trade cost for foreign investment and stimulate demand for imports in turn. As a result, a series of adjustments finally improves the country's economy. However, given that 19 countries in the eurozone share one currency, once the Greek sovereign rating downgrades, the currency will transfer from the downgraded area to an unaffected area instead of lead to the devaluation of the euro.[59] Therefore, there is no increased export demand in a downgraded country. This implies that not only can the downgraded country not improve its economy, but there is also an intrachain influence in the whole eurozone.

To sum up, first, the United States' mature underlying bond market drives the CRA industry to emerge and evolve. US CRAs have almost a century's history and advanced expertise and rating methodologies. During the globalization in the 1970s, with no market entry limits, US CRAs could easily access the EU rating market. The two points could, to a large extent, explain why the US CRAs own the major global market shares, which also underpinned the current oligopolistic rating market. Next, the euro area crisis has special influence on EU regulation, which provides political incentives for EU leaders to break the oligopoly, reduce the over-reliance on CRAs, especially foreign CRAs, and promote the local CRAs industry. This will be analysed in the chapters that follow. In addition, the huge impact of sovereign downgrades in the European Union also gives other countries a warning, including China.

<https://www.europarl.europa.eu/RegData/etudes/BRIE/2016/589865/EPRS_BRI(2016)589865_EN.pdf> accessed 10 March 2019.

[58] Christian Scheinert (n 57).

[59] Baum, Schäfer and Stephan (n 56).

As can be seen from the subsequent Chinese regulation, China has scruples about allowing foreign CRAs to enter into its domestic market. [60]

2.3.4 The Belated Chinese Bond and Credit Rating Market

Unlike the US corporate bond market, the bond market cannot be regarded as a sufficient driver for the emergence of CRAs in China. For long periods, dominant issuers in the Chinese bond market were mainly governments and state-owned enterprises (hereafter 'SOEs'). Investors possessed an innate trust in government bonds (including treasuries and local government bonds) and authorities' bonds (such as central bank bills) and the demand for a credit rating system was thus not very high. Until 1986, the People's Bank of China (hereafter 'PBOC') permitted local enterprises to issue bonds for the first time.[61] Later, in 1987, with the enactment of the Temporary Regulations on the Management of Enterprise Bonds[62], provincial banks were encouraged to set up CRAs as a subsidiary. In this regard, the Jilin Province Credit Rating Corporation was created as a subsidiary of banks in 1987, which can be regarded as the first official CRA in China.[63] As the regulation promotes the setting up of CRAs, many banks set up a CRA as a subsidiary.[64] In 1988, the first private CRA was established, namely the Shanghai Far East Credit Rating Co., Ltd (hereafter 'Shanghai Far East')[65], which was independent of any financial institution.[66]

Why is the Chinese bond market unable to provide sufficient demand for a credit rating industry? To answer this question, it is necessary to analyse the historical background to the Chinese bond market. With the establishment of the People's Republic of China in 1949, the

[60] Until 2020, only S&P had received approval to enter into the Chinese rating market. See Lianting Tu, 'S&P Global Gets Approval for China Local Rating Business' *People's Bank of China* (Bloomberg, 2019) <https://www.bloomberg.com/news/articles/2019-01-28/s-p-global-gets-regulator-nod-for-china-local-rating-business> accessed 6 August 2019.

[61] Credit Research Center of Shanghai University of Finance and Economics [上海财经大学信用研究中心], *2015 China Financial Development Report: Theory, Exploration and Practice of Social Credit System Construction [2015 中国金融发展报告: 社会信用体系建设的理论、探索与实践]* (The Press of Shanghai University of Finance and Economics [上海财经大学出版社] 2016) Chapter 15.

[62] Regulations on the Administration of Corporate Bonds [企业债券管理条例] (Order No. 121 [1993] of the State Council [国务院 [1993]121 号]).

[63] Credit Research Center of Shanghai University of Finance and Economics[上海财经大学信用研究中心] (n 61).

[64] ibid.

[65] Far East Credit [远东资信评估有限公司] <http://www.sfecr.com/ydgk/index_13.aspx> accessed 6 July 2019.

[66] Credit Research Center of Shanghai University of Finance and Economics[上海财经大学信用研究中心] (n 61).

Chinese Central People's Government (hereafter 'CCPG')[67] first issued national bonds in 1950, namely the RenMin ShengLi ZheShi' Government Bond[68], and then between 1954 and 1958, the CCPG issued government bonds five times, namely the National Economic Construction Government Bond[69]. However, the Chinese government stopped issuing any bonds in the following 20 years, since they were affected by the Leftist Impatience and Rashness Thoughts.[70] Owing to the financial deficit caused by a series of economic policies, the government overdraft from the national bank in 1979 and 1980 triggered currency inflation.[71] In order to improve the inflation rate, in 1981, the Ministry of Finance of the People's Republic of China (hereafter 'Ministry of Finance') resumed its issue of sovereign bonds.[72] This marked the beginning of the modern Chinese bond market. The fact that until 1987 enterprise bonds were allowed to be issued, the development of the private sector was far from its counterpart in the United States in the early of twentieth century.

Since the establishment of the first CRA in 1987, a large number of CRAs followed and more than 90 CRAs came into being as subsidiaries of banks all over the country.[73] Nevertheless, all the CRAs established by banks were compulsorily revoked in 1989, according to the Notice of Revocation of Securities Companies and CRAs set up by the

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[67] From 1949 to 1954, the CCPG [中国中央人民政府] was the chief administrative authority of the People's Republic of China and has been replaced with the State Council of the People's Republic of China [中华人民共和国国务院]. See Article 47, 1954 Constitution of the People's Republic of China [中华人民共和国宪法(1954 年)].

[68] [人民胜利折实公债], See 4th Session of Chinese Central People's Government, 'Decision on the Issuance of People's ShengLi ZheShi Governmental Bonds[关于发行人民胜利折实公债的决定]' (1949) <http://www.npc.gov.cn/wxzl/wxzl/2000-12/10/content_4239.htm> accessed 10 October 2019.

[69] [国家经济建设公债]. See 'Rules on 1954 National Economic Construction Government Bond [1954 年国家经济建设公债条例]' the 29th Session of Chinese Central People's Government, 9 December 1953; 'Rules on 1955 National Economic Construction Government Bond [1955 年国家经济建设公债条例]' the 3rd Session of the National People's Congress Standing Committee, 20th December 1954; 'Rules on 1956 National Economic Construction Government Bond [1956年国家经济建设公债条例]' the 26th Session of the National People's Congress Standing Committee, 10th November 1955; 'Rules on 1957 National Economic Construction Government Bond [1957 年国家经济建设公债条例]' the 52th Session of the National People's Congress Standing Committee, 29th December1956; 'Rules on 1958 National Economic Construction Government Bond [1958 年国家经济建设公债条例]' the 83th Session of the National People's Congress Standing Committee, 10th November 1957.

[70] The Great Leap Forward [大跃进], from 1958 to 1962, was an economic and social campaign, which finally resulted in the Great Chinese Famine and tens of millions of deaths. See Dennis Tao Yang, 'China's Agricultural Crisis and Famine of 1959–1961: A Survey and Comparison to Soviet Famines' (2008) 50 Comparative Economic Studies 1.

[71] Jialun Li [李加伦], 'The Stroy behind the Resumption of Treasury Bond in 1980 [1980 年恢复'国库券'发行鲜为人知的幕后故事]' *Liberation Daily [解放日报]* (11 October 2006) <http://news.hexun.com/2008-07-10/107332744.html> accessed 8 October 2018.

[72] Daxing Jiang [蒋大兴], 'A Neglected History of The Bond System [被忽略的债券制度史]' [2012] Journal of Henan University of Economics and Law [河南财经政法大学学报] 17.

[73] Credit Research Center of Shanghai University of Finance and Economics[上海财经大学信用研究中心] (n 61).

PBOC.[74] In this period, the role of CRAs was replaced with credit rating committees but few cities had credit rating committees.[75] Hence, the credit rating industry once again came to a halt.

Until 1993, pursuant to the Regulations on the Management of Enterprise Bonds[76] issued by the State Council of the People's Republic of China (hereafter 'State Council')[77], an issuer of enterprise bonds could apply for credit ratings from recognized CRAs. In 1996, all the enterprise bonds issued or purchased on both the Shanghai Stock Exchange (hereafter 'Shanghai Exchange') and the Shenzhen Stock Exchange (hereafter 'Shenzhen Exchange') were required to apply for credit ratings from rating agencies that were recognized by the China Securities Regulatory Commission (hereafter 'CSRC')[78].[79] In 1997, the PBOC first authorised nine CRAs which were exclusively allowed to provide credit ratings of enterprise bonds.[80] In addition, all the issuers of enterprise bonds should be rated by these nine CRAs before issuance.[81] In 2003, the NDRC officially required issuers of enterprise bonds to provide credit ratings.[82] In 2004, according to the Interim Provisions on the Administration of the Monetary Market Funds[83], money market funds were not allowed to invest in enterprise bonds below a AAA rating. In addition, the PBOC announced the credit rating

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[74] People's Bank of China, 'Notice of Cancellation of Securities Companies and Credit Rating Agencies Established by People's Bank of China [关于撤销人民银行设立的证券公司、信誉评级公司的通知]' No.272 [1989] of the People's Bank of China [银发［1989］272 号].

[75] People's Bank of China, 'Notice of The Establishment of Credit Rating Council [关于设立信誉评级委员会有关问题的通知]' No.211 [1990] of the People's Bank of China [银发[1990]211 号].

[76] Regulations on the Administration of Corporate Bonds [企业债券管理条例].

[77] [中华人民共和国国务院]

[78] [中国证券监督管理委员会]

[79] Shanghai Stock Exchange, 'Corporate Bonds Listing Rules of Shanghai Stock Exchange [上海证券交易所企业债券上市管理规则]' (1996); Shenzhen Stock Exchange, 'Corporate Bonds Listing Rules of Shenzhen Stock Exchange [深圳证券交易所企业债券上市管理规则]' (1996).

[80] The 9 recognized credit rating agencies include China Chengxin Securities Evaluation (the predecessor of China ChengXin International) [中国诚信证券评估有限公司（现在的中诚信国际信用评级有限责任公司]、 Dagong Credit [大公国际资信评估有限责任公司], Shenzhen Securities Evaluation Co., Ltd (the predecessor of Pengyuan) [深圳市资信评估公司（现在的鹏元资信评估有限公司], Far East Credit [上海远东资信评估公司]、Shanghai Brilliance Credit Rating & Investors Services [上海新世纪投资服务公司) and others [辽宁省资信评估公司、福建省资信评级委员会、云南资信评估事务所、长城资信评估有限公司]. See People's Bank of China, 'Notice of the Qualification of China Chengxin Securities Evaluation Co., Ltd. and Other Agencies to Engage in Corporate Bond Credit Rating Business [关于中国诚信证券评估有限公司等机构从事企业债券信用评级业务资格的通知]' No. 547 [1997] of the People's Bank of China [银发[1997] 547 号].

[81] ibid.

[82] 'Notice on The Issuance Scale and Issuance Approval of State Grid Corporation and Other Enterprises' Bonds [关于下达国家电网公司等企业债券发行规模及发行审批有关问题的通知]' No. 1179 [2003] of the National Development and Reform Commission [发改财金[2003]1179 号].

[83] Interim Measures for the Administration of Money Market Funds [货币市场基金暂行管理办法] (No. 78 [2004] of China Securities Regulatory Commission [证监发[2004]78 号]).

requirement in the interbank market in January 2005.[84] In addition, the China Insurance Regulatory Commission (hereafter 'CIRC')[85] required insurance companies exclusively to invest corporate bonds with at least AA ratings.[86] As a result, the credit rating system in the Chinese bond market, ranging from over-the-counter (hereafter 'OTC') market to exchanges, has gradually been established.

A clear difference can be found between CRAs in China and those in the United States and European Union when their respective histories are compared. Although the Chinese CRA industry was, to some extent, driven by the inherent market demand, the relevant legislation and regulation had a much more important effect on the evolution of Chinese CRAs, especially compared with the United States and European Union. The CRA industry seems regulation- rather than market-driven. One reasonable explanation behind that is that before the Chinese economic reform in 1978, the economic system in China was a planned economy whose most obvious characteristic was governmental intervention in the economy. Even though China had begun to enter into a market economy system since 1978, governmental intervention still exists. Because the establishment and development of the Chinese bond and credit rating markets are comparatively late compared with the European Union and United States, China did not allow foreign CRAs to directly provide a credit rating service until 2017.[87] This may avoid the oligopoly of US CRAs, as will discussed in the Chapter 5.

2.3.5 The Issuer-Pays Model

At present, the most common business model worldwide is the issuer-pays model, while at the beginning of the credit rating industry, most CRAs charged subscribers (investors), namely the subscriber-pays model (investor-pays model).

From 1909 to the 1970s, the major operation revenue of the United States' CRAs was from subscription fees, and this business model was the subscriber-pays model.[88] Initially, bond issuers opposed the rating agencies and they regarded the ratings as an intrusion into

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[84] Credit Research Center of Shanghai University of Finance and Economics[上海财经大学信用研究中心] (n 61).
[85] [中国保险监督管理委员会]
[86] Bingxi Shen[沈炳熙] and Yuanyuan Cao [曹媛媛], *China Bond Market: Reform and Development in the Past 30 Years* [*中国债券市场 30 年改革与发展*] (2nd edition, University of Peking Press 2014) 157.
[87] Announcement on Issues Concerning Providing Credit Rating Services by the Credit Rating Agencies in the Interbank Bond Market Announcement [信用评级在银行间债券市场开展信用评级业务有关事宜公告] (Announcement No. 7 [2017] of the People's Bank of China [中国人民银行 公告[2017]第 7 号]).
[88] Partnoy (n 20).

corporation business.[89] However, high ratings objectively increased the channels of funding so bonds issuers had to provide valuable information to CRAs so as to improve their ratings.[90] Based on the valuable information that sometime included non-public information provided by issuers, CRAs published accurate ratings and thus became credible.[91] Gradually, credit ratings became important for both issuers and investors.

The trend to the issuer-pays model was hinted at during the 1930s. Although there was a decline in confidence in credit ratings, institutions still relied on credit rating to different degrees during the 1930s. Large New York banks only regarded credit ratings as a double check, while the smaller local banks regarded ratings as authoritative guides in assessing credit risks of securities. In terms of insurance companies, their own analysts played a more important role rather than ratings from other CRAs. By contrast, credit ratings were considered significant in trust companies.[92] For example, Dillman A. Rash from the Louisville Trust Company stated that 'the AAA rating . . . was the only way we were able to sell it to our Trust Investment Committee'.[93] At that time, a study by Gilbert Harold tried to reveal whether changes in credit ratings had an influence on market prices. As Harold's study implied, the market value of bonds with high ratings would increase within a certain period, or the reverse would apply.[94] If a CRA raises one bond's rating, the bond would be purchased at higher prices, which means that high-rated bonds have better liquidity.[95]

The change of business model from investors-pays model to issuers-pays model happened in the 1970s. In 1970, Moody's and Fitch began to shift their business model from the subscriber-pays model to the issuer-pays model. Later in 1974, S&P began to charge issuers.[96] There were three reasons behind the change. First and foremost, the CRA was utilised by regulatory tools in the 1970s, as discussed above. Second, photocopying technology made credit ratings widely available for investors at a low cost.[97] It was hard for CRAs to prevent widely spreading their ratings from subscribers to non-paying investors.

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89 ibid.
90 ibid.
91 ibid 640.
92 ibid 645.
93 Gilbert Harold (n 24) 23.
94 'There is a very definite tendency for the market value of specifically recommended bonds to rise within ten days after publication of the 'buy' advice, and, conversely … there is a definite tendency for the market value of 'sell' bonds to decline within the same immediate period.' See Gilbert Harold, 'Accuracy in Reading the Investment Spectrum' (1934) 27 American Bankers Association, 32.
95 Gilbert Harold (n 24) 191.
96 Lawrence J. White (n 46) 12.
97 ibid.

Third, on the heels of the liquidity crises, the 1970 Penn Central default on USD 82 million in commercial paper drew attention to the credit risk.[98] Therefore, issuers had incentives to actively seek ratings so that they would more likely be trusted by investors.[99] Until now, the issuer-pays model had been the most common business model.

The regulatory status of CRAs is the key to the issuer-pays model. The basic function of credit rating is to reduce the information asymmetry between the investors and rated entities in financial markets. This function creates direct incentives for investors instead of issuers to purchase rating services. Nevertheless, when regulation depends on credit ratings to identify and select bonds, issuers have sufficient incentives to purchase ratings from CRAs.

2.4 The Regulatory Regimes of Credit Rating Agencies

2.4.1 The United States Regime

CRAs in the United States should register with the SEC and those that receive authorization and certification from the SEC become NRSROs. In the United States, the SEC is a centralized regulator for NRSROs and other relevant securities issues. According to section 932 (a) (8) of the Dodd–Frank Act, the Office of Credit Ratings (hereafter 'OCR') has been created as a specific regulatory body within the SEC. The legislation empowers the OCR to regulate NRSROs and to implement the relevant SEC rules, ranging from disclosure to conflicts of interest. In addition, the OCR was established to ensure the accuracy of the credit rating, and to protect rating users and the public interest.[100]

Even though NRSROs were used for long periods, the term was defined for the first time in 2006 under the CRARA. NRSROs had not been regulated for long periods until CRARA empowered the SEC to oversee NRSROs that registered with the SEC, and thus the SEC became the primary regulator of NRSROs. CRARA added section 15E to the Exchange Act, and this section established the current regulatory framework applicable to NRSROs. CRARA aims to 'to improve ratings quality for the protection of investors and is in the public interest by fostering accountability, transparency, and competition in the credit rating agency

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[98] ibid.
[99] ibid.
[100] Nan S. Ellis, Lisa M. Fairchild and Frank D'Souza (n 2) 25.

industry'.[101] Later in 2007, the SEC adopted a series of rules[102] to regulate NRSROs to implement the registration and supervision framework under CRARA. Rule 17g-1 provides specific eligibility criteria for a CRA to apply for NRSRO registration with the SEC. Rule 17g-2 requires NRSROs to make and maintain the records associated with its business for certain prescribed periods. Rule 17g-3 requires NRSROs to furnish the audited financial statements to the SEC on an annual fiscal year basis, which aims to assist the SEC in monitoring the integrity of NRSROs. Under Rule 17g-4, a NRSRO is required to establish, maintain, and enforce written policies and procedures so as to prevent the misuse of material non-public information. Rule 17g-5 requires NRSROs to establish and maintain an adequate structure of internal controls to manage, avoid and disclose conflicts of interest. Under Rule 17g-6, a CRA would be prohibited from engaging in certain 'unfair, coercive or abusive practices'. Although CRARA and these rules aim to improve the registration, transparency and oversight of NRSROs, the SEC, pursuant to section 15E of CRARA, does not have the power to regulate the rating content, procedures and methodologies of NRSROs.

After the financial crisis, the Dodd–Frank Act was designed to improve the regulation of NRSROs by setting out specific rules derived from sections 931 to 939H. Besides the OCR mentioned above, there were three changes under the Dodd–Frank Act. First, section 939A requires the relevant regulators to review each rating-based rule in their regulations and remove those rating-based rules that induce uncritical reliance on external credit ratings as well as replace them with alternative standards[103] Second, section 932 requires NRSROs to establish more independent corporate governance, greater internal controls, and more expansive and accessible disclosure of ratings and rating basis in order to better manage potential conflicts of interest.[104] Third, the Dodd–Frank Act enhanced the civil liability of CRAs so that investors can claim damage under a private cause against CRAs.[105]

2.4.2 The European Union Regime

CRAs were not officially regulated until the financial crisis. After the financial crisis, the EU realised the deficiency of self-regulation and took a series of regulatory measures to better regulate CRAs. CRAs haven't been regulated for long periods in EU. Until the

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[101] Credit Rating Agency Reform Act of 2006 (Pub L No. 109–291,120 Stat 1327), 1.
[102] The rules range from the 17 CFR 240.17g-1 to 17 CFR 240.17g-6. See SEC, 'Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations' (2007) Release No. 34-55231; File No. S7-04-07 <https://www.sec.gov/rules/proposed/2007/34-55231.pdf> accessed 10 November 2018.
[103] Section 939 A of the Dodd–Frank Act
[104] Section 932, the Dodd-Frank Act 2010 (Public Law 111-203).
[105] Section 931, 933 and 939G, ibid.

financial crisis of 2008, the EU realized the important role of CRAs in financial markets. Later, the following euro area crisis arising from sovereign downgrades further affirmed the importance of enhancing the regulation of CRAs. To better regulate the financial market, the European Securities and Markets Authority (hereafter 'ESMA') was specially designed to regulate CRAs. During just five years (2009–2013), there were three Acts that especially aimed at regulating CRAs, namely (i) Regulation (2009/1060/EC) (hereafter 'Regulation 2009'), (ii) Regulation (2011/513/EU) (hereafter 'Regulation 2011') and (iii) Regulation (2013/462/EU) (hereafter 'Regulation 2013').

Regulation 2009 was designed to establish a harmonised EU-wide regulatory framework for CRAs. Regulation 2009 targets the improvement of the problems of conflicts of interest and rating quality. This regulation also provides for the registration and certification requirements for CRAs in the European Union. Regulation 2009 marked the first official regulatory framework applicable to CRAs, and also implies that the European Union was ready to set higher and more stringent regulatory standards.

Subsequently, according to Regulation 2011, ESMA was established and designed specifically to regulate CRAs so that these regulations mentioned could be effective. Unlike the former supervisory regulator, namely the Committee of European Securities Regulators (hereafter 'CESR'), ESMA is a centralized and more powerful authority. The role of CESR is more like an advisory group to assist the EU Commission and even though it has supervisory function, its power was still limited.[106] In order to regulate CRAs throughout the entire EU market, ESMA was empowered to request all the information needed under Article 23(b) of Regulation 2011 and conduct the necessary investigation of persons concerned under Article 23(c) of Regulation 2011.

Regulation 2013 further deepens CRA reforms by giving more provisions pertaining to managing conflicts of interest, reducing over-reliance on CRAs and increasing competition in the CRA industry. Among these reforms, Regulation 2013 designed a rotation mechanism so as to foster competition and to break the oligopoly of the CRA market.[107] Most importantly, in order to enhance the market confidence in CRAs, Regulation 2013 created a

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[106] Dorothee Fischer-Appelt, 'The European Securities and Markets Authority: The Beginnings of a Powerful European Securities Authority?' (2011) 5 Law and Financial Markets Review 21, 22 <https://www.tandfonline.com/doi/full/10.5235/175214411794390057> accessed 14 December 2020.
[107] Article 6, Regulation (EU) No. 462/2013 of the European Parliament and of the Council of 21 May 2013 Amending Regulation (EC) No. 1060/2009 on Credit Rating Agencies (OJ 2013 L 146).

civil liability regime for CRAs so that investors and issuers without contracts can claim damages against CRAs.[108]

2.4.3 The China Regime

a. Background to the Multi-Supervision System

The biggest regulatory concern regarding CRAs in China is the multi-regulator supervision system. The root of the concern could originate from the supervisory system in the bond market. The history of the Chinese bond market could be divided into three main periods since its establishment in 1981.[109] First (from 1981 to 1991) the number and types of bonds are limited, and most are national government bonds. Until 1990, there were ten different negotiable national government bonds.[110] In addition, the OTC market is the main trading platform.[111] Second (between 1992 and 2000), with the establishment of the Shanghai Exchange in 1990 and the Shenzhen Exchange in 1994, the main trading places for bonds gradually became the exchanges. Many serious shorts and financial fraud took place in the OTC market in 1995, which reflected the potential management risks in that market. To control the risks and better regulate bond market, OTC as trading platform was forbidden in the trading off bonds. As a result, the Shanghai and Shenzhen exchanges became the exclusive legal bonds trading platform.[112]

Third, since 2001, the interbank market has become the main bonds trading platform, which is a remarkable change for the multi-regulator system. As mentioned before, even though the legal bonds trading platforms were established, namely the Shanghai and Shenzhen exchanges, the supporting risk-control legal framework had not yet been formed. Thus, it was easy to raise capital for issuers through bonds repurchases and, at the same time, there were frequent bond trading violations, such as the 327 Treasury Futures Event.[113] In order to enhance the stability of the financial market, regulators attempted to decrease potential

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108 Article 35a, ibid.

109 Daxing Jiang [蒋大兴] (n 72).

110 Bingxi Shen [沈炳熙] and Yuanyuan Cao [曹媛媛], *China Bond Market: Reform and Development in the Past 30 Years* [*中国债券市场 30 年改革与发展*] (2nd edition, University of Peking Press 2014) 6.

111 Duo Xie [谢多], 'The Challenges and Prospect of The Opening-Up Bond Market [债券市场对外开放的挑战和未来]' (2016) <http://finance.sina.com.cn/meeting/2016-08-22/doc-ifxvcsrn8920821.shtml> accessed 8 August 2018.

112 Bingxi Shen[沈炳熙] and Yuanyuan Cao [曹媛媛] (n 87) 7.

113 One of big bonds violations events during that periods is the 327 Treasury Event. See Yi Lu [陆一], *Chinese Gambler: The Beginning and End of The 327 Treasury Event* [*中国赌金者: 327 事件始末*] (上海远东出版社 2015) 183.

risks in the bond market. However, owing to the unsophisticated regulatory ability at that time, regulators could only design a separate bonds trading platform especially for the banking industry because financial institutions play a vital role in the whole financial market and generally have comparatively high credit. In 1997, the PBOC, the Chinese central bank and other financial regulator, required all commercial banks to exit from the exchanges.[114] Therefore, commercial banks are only allowed to purchase or repurchase bonds through the transaction system of interbank. Later, on 16 June 1997, the national interbank bond market was officially formed. As shown in Table 2.2, in 2001, the number of bond transactions in the interbank market exceeded the counterpart in exchanges for the first time and the gap continues to widen. So far, in terms of the number of bonds issuance, custody and transaction, the interbank market has been the biggest platform in China, compared to the exchanges and the OTC market. The interbank market possesses more than 95 per cent of the bond market.[115]

[114] People's Bank of China, 'Notice of the People's Bank of China on The Cessation of Securities Repurchase and Cash Trading by Commercial Banks at The Stock Exchange [中国人民银行关于各商业银行停止在证券交易所证券回购及现券交易的通知]' No. 240 [1997] of the People's Bank of China [银发 [1997] 240 号].
[115] Bingxi Shen[沈炳熙] and Yuanyuan Cao [曹媛媛] (n 82) 36.

Table 2.2 A comparison of trading platforms in the Chinese bond market from 1997 to 2012

	Amount of bond transaction (billion yuan)		Amount of bond custody (billion yuan)	
Trading platform	**Interbank market**	**Exchanges**	**Interbank market**	**Exchanges**
1997	336	1 6439	4 121	/
1998	1 096	2 1601	9 884	/
1999	4 664	1 8191	13 189	/
2000	16 363	1 8892	16 746	/
2001	41 030	20 304[116]	19 728	/
2002	106 322	33 129	25 584	/
2003	151 369	58 057	33 512	4 113
2004	127 849	47 054	46 745	4 699
2005	228 457	26 040	68 495	4 128
2006	382 840	16 954	88 387	3 785
2007	628 788	19 612	119 708	3 646
2008	1 008 224	26 391	147 142	4 491
2009	1 214 412	37 561	171 058	4 947
2010	1 552 808	67 539	197 302	6 279
2011	1 672 120	200 841	206 370	8 428
2012	2 125 553	347 242	241 896	1 245

b. Main Regulators of the Bond Market and Credit Rating Agencies

The bond market regulation in China is in the charge of several regulators according to various bond trading platforms. The main bonds trading platform includes exchanges and the interbank market. In order to ensure easier and more convenient supervision and regulation, the PBOC has the power to regulate and supervise bonds in the interbank market, while the CSRC supervises and regulates bonds on the stock exchanges.

As seen in Table 2.3, from the perspective of bond type, the main types of bonds include government bonds, financial bonds, corporate bonds and enterprise bonds. Unlike bonds issue in the United States, namely submitting required information and registering with the

[116] From 2001, the amount of bonds transactions in interbank market has exceeded that in the exchange market.

SEC, Chinese bonds issue is required to be examined substantially and approved in limited quantity by the particular regulator, which could be regarded as a stringent requirement of bonds issue and objectively increases the regulatory burden on the regulator. Nowadays, the Chinese bonds issuance examination mechanism is inclined to be looser and open to the market. First, the Ministry of Finance is the nominal issuer of treasury bonds and local government bonds, and it has the power to approve the issuance of government bonds. The government bonds mainly include treasury bonds, local government bonds, central bank bills and others. Because the *de facto* issuers of treasury bonds, local government bonds and enterprise bonds issued by SOEs are governmental authorities, whichever bond defaults, the governmental authorities are more likely to pay it back. Second, the PBOC has the power to approve the issue of financial bonds. The issuer of a financial bond is a financial institution, which generally has a higher credit rating compared to a company. In China, in order to protect financial stability, all financial bonds are issued and circulated in the interbank market.[117] Financial bonds mainly consist of policy financial bonds and commercial financial bonds. The issuer of policy financial bonds are three recognised banks, namely (i) the China Development Bank, (ii) Exim Bank of China and the (iii) Agriculture Development Bank of China.[118] Third, the CSRC has the power to approve the issue of corporate bonds. According to Article 2 of the Company Law of the People's Republic of China (hereafter ‘Company Law’), the issuer of corporate bonds cannot be anything but a limited liability company or a joint stock company.[119] By contrast, enterprise bonds have a longer history and can date back to 1985. At that time, the State Development Planning Commission (the predecessor of the NDRC) was in charge of all SOEs and the issuing of bonds of such enterprises. In addition, the requirements of examining and approving enterprise bonds were once extremely strict. Therefore, the issuer of enterprise bonds, in fact, had been confined to SOEs for a long period, even though there was never any regulation to limit the scope of the issuers of enterprise bonds. Entering into the twenty-first century, non-SOE companies as the issuer of enterprise bonds began to appear. At present, besides the difference in issuers between corporate bonds and enterprise bonds, the most important difference is the issue system. In terms of corporate bonds, the CSRC just verifies the

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[117] Article 13 of Measures for the Administration of the Issuance of Financial Bonds in the National Inter-bank Bond Market [全国银行间债券市场金融债券发行管理办法] (No. 1 [2005] of the People’s Bank of China [中国人民银行令[2005]第 1 号]).

[118] [国家开发银行], [中国进出口银行] and [中国农业发展银行].

[119] Article 2 provides that ‘the term of ‘Company’ as mentioned in the law refers to a limited liability company or a joint stock company limited set up within the territory of the People’s Republic of China according to the provisions of this law. ‘[第二条 本法所称公司是指依照本法在中国境内设立的有限责任公司和股份有限公司。] Company Law of the People’s Republic of China [中华人民共和国公司法] (Sixth Session of the Standing Committee of the 12 the National People’s Congress on December 28, 2013).

information provided by the applicant and there is no limit on the annual issue amount of corporate bonds. Nevertheless, the requirement of issuing enterprise is comparatively high, and the NDRC not only examines the applicant and strictly controls the issue amount of enterprise bonds.[120] Owing to the examination and approval mechanism in the Chinese bond market, different regulators means various levels of rigorous bond issue requirements and various regulatory standards, such as information disclosure and conflicts of interest.

Table 2.3 Table various types of bonds and trading platforms by different regulators in China

Regulator	Bonds trading platform	Type of bonds
Ministry of Finance	Both stock exchanges and interbank market	Treasury bond
		Government bond
NDRC	Both stock exchanges and interbank market	Enterprise bond
CSRC	Stock exchanges	Corporate bond
PBOC	Interbank market	Financial bond
		Medium term note
		Short-term and super short-term commercial paper

Chinese bonds mainly include sovereign bonds and government bonds, financial bonds, corporate bonds and enterprise bonds. The reason for the different categories of bonds is because they are regulated by different regulators. The Chinese bond market developed rapidly in the recent decades. Between 1981 and 1984, the annual average market value of Chinese sovereign bonds was approximately 4 billion yuan.[121] In February 2018, as Table 2.4 and Figure 2.1 illustrate, the monthly market value of Chinese sovereign bonds is approximately 10 409 billion yuan and the monthly market value of Chinese government bonds is approximately 11 098.6 billion yuan, which occupies 42.77 per cent of the whole Chinese bond market (20.70 and 22.07 per cent respectively). Financial bonds are worth nearly 20 000 billion yuan (more than 40 per cent). Corporate bonds and enterprise bonds are worth 3 112.56 and 2 924.3 billion yuan respectively, and amount to 6.19 and 5.81 per cent respectively. According to Figure 2.2, the four regulators occupy various proportions

[120] Bingxi Shen[沈炳熙] and Yuanyuan Cao [曹媛媛] (n 82) 146-48.
[121] Daxing Jiang [蒋大兴] (n 72).

of Chinese bond market and this also reflects the Chinese supervision system in the bond market. In the primary market, the CSRC, PBOC, Ministry of Finance and NDRC are in charge of corporate bonds, financial bonds, government bonds and enterprise bonds respectively. In the second market, the PBOC supervises the OTC and interbank market, while the CSRC supervises the stock exchanges market. In this regard, the Chinese supervision system with multi-regulators stemmed from the bond market. There are some influences under this supervision system: on the one hand, owing to the various types of bond issue being examined and approved by different regulators, regulatory gaps and regulatory arbitrage exist. Some novel bonds take advantage of the regulatory gaps or regulatory arbitrage, which creates the unfairness on different trading platforms. In addition, the regulatory system easily gives rise to regulatory overlap, especially when the supervising scope of regulators is not clearly defined. This may waste regulatory sources, decrease supervision efficiency and there is competition and comparison between regulators. Regulators thus should reform and improve the existing regulatory framework in order to co-build a competitive and fair bond market.

Table 2.4 Chinese market value by various types of bonds in February 2018[122]

Bond type	Market value(billion yuan)
Treasury bond	10,409.016
Government bond	11,098.587
Financial bond	14,554.304
Medium term note	4,895.72
Short-term and super short-term commercial paper	1,640.06
Enterprise bond	2,924.319
Corporate bond	3,112.55
others	16,604.97
In total	502,950.53

[122] Data collected from China Bond, 'Monthly Bulletin of Statistics February 2018 中债指数统计月报 2018 年 2 月]' <https://www.chinabond.com.cn/Channel/147253508> accessed 2 April 2018.

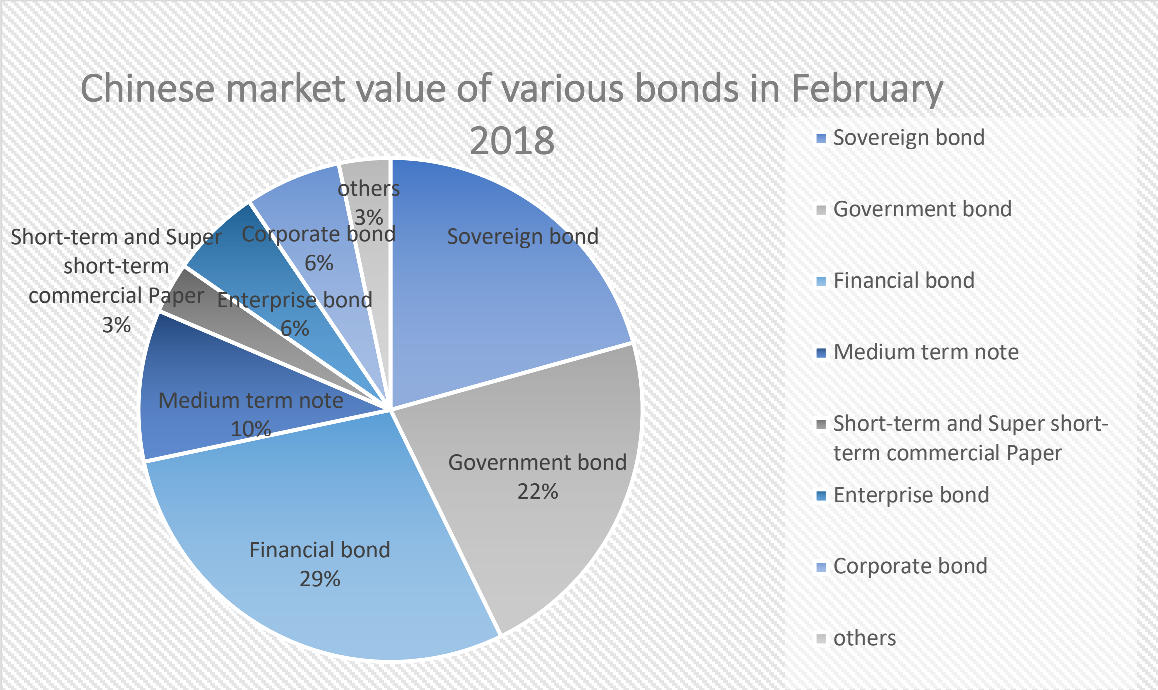

Figure 2.1 The percentage of Chinese market value of various bonds in February 2018[123]

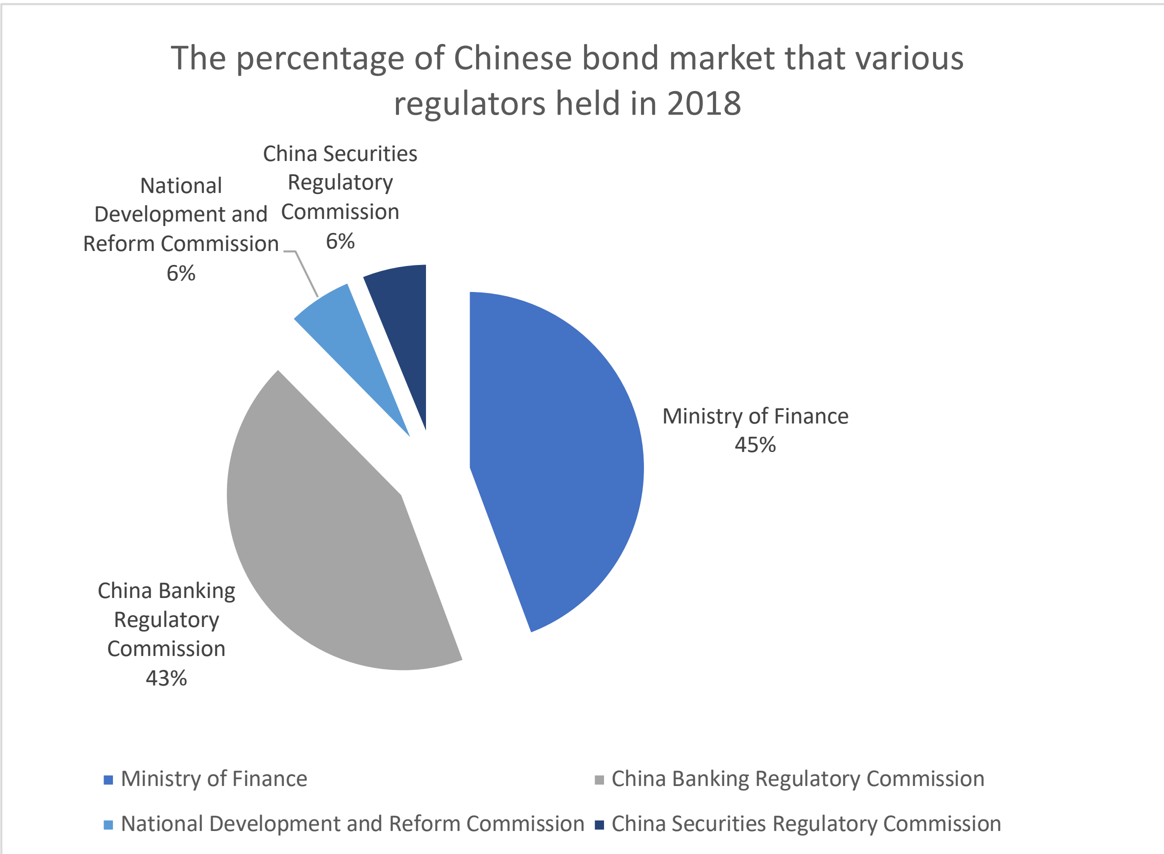

Figure 2.2 The percentage of bond market that various regulators held in 2018[124]

[123] Data collected from ibid.
[124] Data collected from ibid.

As discussed above, the supervision system of multi-regulators in the bond market has a decisive influence on the regulatory system for CRAs. Prior to December 2019, the credit rating industry lacked a unified standard of recognised CRAs. Unlike NRSROs in the United States, different regulators have different approval standards on different trading platforms. Because of the various requirements, there are different recognised CRAs in China. Besides the nine CRAs recognised by the PBOC in 1997 as mentioned before, the PBOC approved five CRAs in 2005 so that they could provide rating services for bonds issued in the interbank market. However, the PBOC revoked one of the five CRAs, namely Shanghai Far East, and later authorised two more CRAs. In terms of corporate bonds on stock exchanges, the CSRC recognised five CRAs in 2007, and then authorised more separately in 2011 and 2014.[125] With respect to enterprise bonds, the NDRC licensed five CRAs in 2003 and later also revoked Shanghai Far East's certificate and approved two more CRAs separately in 2008 and 2011.[126] Apart from that, the licences issued by CIRC originated in 2003[127] and nowadays CIRC recognises eight CRAs.[128] Bonds issued without the licensee being approved by CIRC cannot be invested by insurance funds. Table 2.5 lists the ten CRAs that are currently recognised by at least one regulator. Simply put, the credit rating of enterprise bonds and corporate bonds is regulated by the NDRC and CRSC respectively, and all credit ratings applied in the interbank market are regulated by the PBOC.

[125] Nan Guo [郭楠], 'Five Important Things Related to the Bond Ratings [关于债券市场评级不得不说的 5 件事]' (1 October 2017) <http://www.sohu.com/a/195899069_667855> accessed 3 May 2018.

[126] ibid.

[127] Shanghai Far East and Lianhe were recognised by the CIRC in 2003. See China Insurance Regulatory Commission, 'Notice on More Recognised Credit Rating Agencies of Enterprise's Bond [关于增加认可企业债券信用评级公司的通知]' No.92 [2003] of China Insurance Regulatory Commission [保监发 [2003]92 号].

[128] In 2013, besides to the two approved CRAs as mentioned above, CIRC recognized five more CRAs, namely Dagong, Shanghai Brilliance Credit Rating & Investors Services, Golden [东方金诚国际信用评估有限公司], China ChengXin International and its relevant subsidiary. See China Insurance Regulatory Commission, 'Notice on Recognition of 7 Credit Rating Agencies [关于认可 7 家信用评级机构能力备案的公告]' No.11 [2013] of China Insurance Regulatory Commission [保监公告[2013]11 号].

In 2014, CIRC issued another approval to the China Bond Rating[中债资信评估有限责任公司]. See China Insurance Regulatory Commission, 'Announcement of the China Insurance Regulatory Commission on the Recordation of Recognized Capability of the Credit Rating Institution[关于认可信用评级机构能力备案的公告]' No.6 [2014] of China Insurance Regulatory Commission [保监公告[2014]6 号].

Table 2.5 The certificates of Chinese main CRAs by four regulators

	NDRC	CSRC	PBOC	CIRC
Dagong Global Credit Rating Co., Ltd (hereafter 'Dagong')[129]	√	√	√	√
Golden Credit Rating International Co., Ltd (hereafter 'Golden')[130]	√	√	√	√
China Chengxin International Credit Rating Co. Ltd (hereafter 'CCXI')[131]	√		√	√
Shanghai Brilliance Credit Rating & Investors Service Co. Ltd (hereafter 'SB&IS')[132]	√	√	√	√
China Lianhe Credit Rating Co. Ltd (hereafter 'Lianhe')[133]	√		√	√
Shanghai Far East		√		
Pengyuan Credit Rating[134]	√	√		
China Chengxin Securities Rating Co., Ltd (hereafter 'CCXR')[135]		√		√
United Credit Rating Co., Ltd (hereafter 'United Ratings')[136]		√		√
China Bond Rating Co., Ltd. (hereafter 'China Bond Rating)[137]			√	√

There are three negative effects of the multi-regulator supervision system. First, the different recognised standards added extra costs to issuers, especially when issuers who have

[129] Dagong Credit [大公国际资信评估有限公司] <http://en.dagongcredit.com/index.php?m=content&c=index&a=lists&catid=11> accessed 6 July 2019.
[130] Golden [东方金诚国际信用评估有限公司] <http://www.dfratings.com/news/info/15> accessed 27 July 2019.
[131] China ChengXin International Credit Rating Co., Ltd (CCXI) [中诚信国际信用评级有限公司] <http://www.ccxap.com/About.aspx> accessed 6 July 2019.
[132] Shanghai Brilliance Credit Rating& Investors Services(SB&IS) [上海新世纪资信评估投资服务有限公司] <http://www.shxsj.com/en/inside.php?menuid=106&catid=116> accessed 6 July 2019.
[133] Lianhe [联合资信评级有限公司] <http://www.lhratings.com/about/jianjie.html> accessed 6 July 2019.
[134] Pengyuan Rating[鹏元资信评估有限公司] <http://www.pyrating.cn/zh-cn/about/zizhizili> accessed 6 July 2019.
[135] China Chengxin Securities Rating (CCXR) [中诚信证券评估有限公司] <http://www.ccxr.com.cn/about.asp?link=4> accessed 6 July 2019.
[136] United Ratings [联合信用评级有限公司] <http://www.lianhecreditrating.com.cn/News.aspx?m=20140627095017653668> accessed 6 July 2019.
[137] China Bond Rating[中债资信评估有限责任公司] <https://www.chinaratings.com.cn/AboutUs/Profile/Overview/> accessed 6 July 2019.

purchased one credit rating that cannot be applied on another trading platform have to purchase an additional credit rating that is recognised by the other regulator. Second, in order to avoid the extra costs, issuers are inclined to choose CRAs that possess four certificates. As a result, the regulatory certificates provide advantages for a few CRAs. As is seen in the Table 2.5, there are only three CRAs with three certificates, namely (i) Dagong, (ii) Golden and (iii) SB&IS. From the credit rating industry's perspective, the regulatory approval itself easily leads to the hurdle of market entry and the multi-regulatory approval further aggravates this unfair competition. Third, the multi-approval supervision system reduces efficiency and wastes regulatory resources. One CRA applies for certificates for all relevant regulators, and every regulator has to review and verify the information provided by the same CRA.

Before analysing whether or not that is a waste, the following question should first be answered: Are these different standards substantially different? That implies if these standards issued by various regulators are really different rather than different on the surface, their presence is rational and necessary. If not, they are merely issued by different regulators, but the requirements are substantially similar that are not necessary or efficient. By comparing the two certificate requirements from the CSRC and PBOC respectively,[138] it is found that most of the requirements are similar and there is no big difference besides the regulators themselves. The reason behind that is for the sake of convenience of supervision the objects and platforms that the two regulators supervise are different. If these regulators could co-operate with each other, the regulation would be more efficient and effective.

Back to the bond market history, in order to protect the banking industry and financial stability, the interbank bond market was established and has regulatory privileges, such as least legal procedures involved in bond issues. On the one hand, these regulations and multi-supervision system provide a more or less stable financial market. Rapid and increasing financial markets boost the development of CRAs. On the other hand, these regulations and the multi-supervision system in reverse limits the further development of CRAs and the regulatory burden reduces the efficiency from the rating industry to the whole bond market.

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[138] The requirements of application for recognised CRAs registered with CRSC, see China Securities Regulatory Commission, 'The Requirements of Application for Recognised Credit Rating Agencies [资信评级机构从事证券服务业审批]' <http://www.csrc.gov.cn/pub/newsite/gszqjgb/fwzn/201603/t20160329_294905.html> accessed 9 September 2018. The requirements of application for recognised CRAs registered with the PBOC, see Guiding Opinions of the People's Bank of China for the Management of Credit Rating [中国人民银行信用评级管理指导意见] (No 95 [2006] of the People's Bank of China [银发[2006]95 号]).

Chinese regulators have realised the problems under the multi-regulator system. In 2016, the PBOC drafted a regulation specifically for CRAs, namely the Interim Measures for the Administration of the Credit Rating Business (exposure draft).[139] In 2019, the PBOC, NDRC, CSRC, NDRC and Ministry of Finance jointly issue the Interim Measures for the Administration of the Credit Rating Industry[140] (hereafter 'Interim Measures 2019'). The Interim Measures 2019 provide that the PBOC is the supervisory body, while the other three regulators are the administrative bodies.[141] In terms of the regulators, both the European Union and United States, have one centralized regulator, namely the SEC (including its branch OCR) in the United States and ESMA in the European Union. Since 2019, even though the PBOC became the supervisory regulator, there are still other administrative regulators as well as the multi-regulator system still exists.

c. Over-Concise Legal Framework

Another regulatory concern is the current incomplete legal framework, and the existing laws and rules regarding CRAs. The current legal framework regarding credit ratings has not completely been established as yet. There is no legislation specially designed for CRAs, and most of the existing regulations regarding credit rating are scattered in different laws and rules, such as the Company Law and the Securities Law of the People's Republic of China (hereafter 'Securities Law'). For instance, all the relevant articles under the Securities Law are followed: First, under Article 169 of the Securities Law, CRAs are required to get approval from the CSRC and the relevant regulators. By contrast, the CSRC is entitled to approve and supervise CRAs. Secondly, Article 170 provides for qualification requirements for the rating analysts in CRAs. Thirdly, as Article 172 states, CRAs are required to charge reasonable fees in accordance with the relevant requirements issued by the State Council. Fourthly, as Article 226 states, if a rating agency is established without the approval of the CSRC and provides rating services in the securities market, the CSRC will impose a fine on it and may revoke its license. Last, Articles 173 and 223 refer to the accountability of CRAs.

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[139] Interim Measures for the Administration of the Credit Rating Industry (exposure draft) [信用评级业管理暂行办法（征求意见稿）] (People's Bank of China [中国人民银行] 2016).

[140] Interim Measures for the Administration of the Credit Rating Industry [信用评级业管理暂行办法] 2019 (No. 5 [2019] of People's Bank of China, the National Development and Reform Commission, the Ministry of Finance and the China Securities Regulatory Commission).

[141] Article 3 of ibid.

However, as illustrated in Table 2.6, the existing regulation is not systematic enough. Some of these rules only contain a few provisions associated with credit rating. Apart from that, on the ground that all existing regulation, except the Company Law and Securities Law, are not at national level but departmental rules and codes, the scope of jurisdiction and binding force are thus limited. For example, the China Banking Regulatory Commission (hereafter 'CBRC')[142] issued one department rule, namely 'Administrative Measures for the Capital of Commercial Banks (for Trial Implementation)'[143], which requires that CRAs should be recognised by the CBRC, otherwise their ratings cannot be applied in the calculation of market risk by commercial banks.[144] This is a departmental rule and should have applied into the commercial banks. Nevertheless, CBRC did not approved any CRA yet and this rule thus has limited binding force in practice. The reason why the lack of CBRC approvals for CRAs is that the actual power for registration, certification and approval has been carved by other regulators. In theory, both the PBOC and the CBRC have right to recognise CRAs that their ratings could be used in the calculation of market risk for commercial banks. In practice, the PBOC is superior regulatory than the CBRC and there is an overlap between the PBOC and the CBRC in approving CRAs associated with capital for commercial banks. As a result, this rule issued by CBRC seems ineffective. As seen the messy situation under a multi-regulators supervision system for CRAs, it is incumbent upon regulator to establish a unified and harmonized regulatory framework for CRAs.

142 [中国银行业监督管理委员会]

143 China Banking Regulatory Commission [中国银监会], 'Administrative Measures for the Capital of Commercial Banks (for Trial Implementation) [《商业银行资本管理办法》（试行）]' No. 1 [2012] of the China Banking Regulatory Commission.

144 Appendix 17, ibid.

Table 2.6 The Existing Regulations and Departmental Codes Regarding CRAs Issued by Various Regulators

Administration	Official documents
CSRC	'Interim Measures for Administration of Credit Rating Business at the Securities Market' (effective since 2008)[145] 'Standards for Credit Rating Report on Bonds of the Securities Companies by CRA' (effective since 2005)[146]
PBOC	'Guiding Opinions of the People's Bank of China for the Management of Credit Rating' (effective since 2006) [147] Specification for credit rating in the credit market and inter-bank market (effective since 2006) [148] 'Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market' (effective since 2019)
State Council	'Interim Regulations on Administration of Enterprise Bonds' (effective since 2011) 'Some Opinions of the State Council on Promoting the Reform, Opening, and Steady Growth of Capital Markets' (effective since 2004)
CBRC	1. 'Administrative Measures for the Capital of Commercial Banks (for Trial Implementation)'(effective since 2012)

In December 2019, the final 'Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market'[149] came into effect. The main changes focus on the following three aspects: first, Interim Measures 2019 provides registration

[145] Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market [证券市场资信评级业务管理暂行办法] (No. 50 [2007] of China Securities Regulatory Commission [证监发[2007] 50 号]).

[146] China Securities Regulatory Commission, 'Standards for Credit Rating Report on Bonds of the Securities Companies by Credit Rating Agency' (2005) <http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69166.html> accessed 2 February 2018.

[147] Guiding Opinions of the People's Bank of China for the Management of Credit Rating [中国人民银行信用评级管理指导意见].

[148] Specification for Credit Rating in the Credit Market and Interbank Market [信贷市场和银行间债券市场信用评级规范] (JR/T00301-3—2006, People's Bank of China).

[149] Interim Measures for the Administration of the Credit Rating Industry [信用评级业管理暂行办法].

requirements[150] and disclosure requirements.[151] Second, it requires CRAs to establish internal controls and corporate governance to prevent conflicts of interest and ensure independence. Third and most importantly, Interim Measure 2019 increases the level of fines and penalties. Interim Measures 2019 revolutionarily establishes a uniform regulatory framework applicable to CRAs and requires regulators to apply consistent standards for CRAs. However, Interim Measures 2019 has not determined what the particular responsibilities for each regulator are and how to regulate CRAs with unified standards in various platforms for different bonds. As analysed above, the multi-regulators for CRAs stemmed from the multi-regulator system in the bond market. A CRA is a financial intermediary, and serves bonds issue and securitization. Bond regulators have various levels of requirements, such as disclosure and capital requirements, that are designed for various bonds and different issuing platforms. Therefore, regulation of CRAs cannot separate the CRA issues from its based bond market.

The key problem during the multi-regulator phase is that the various regulators issue certificates to various CRAs. This problem has not changed. The Interim Measures 2019 aim to establish a uniform certification standard. However, this increases the approval standard. Since the Interim Measures 2019, so far, the PBOC and the other three regulators have not issued any new CRA with a certificate of approval.[152] This may create barriers to market entry and impede effective market competition. Compared to the CRA regime of the European Union and United States, the China regime for CRAs seems comparatively overly concise and unsystematic.

2.5 Conclusion

Having illustrated the evolution of CRAs and the relevant regulatory systems in the European Union, United States and China respectively, it observes that the varying degrees of development in credit rating industry lead to various problems encountered by each region. The United States has almost one-century history of CRAs. For one thing, the US bond market provides the sufficient demand for reducing information asymmetry between bond issuers and investors. For another, the SEC created the regulatory license, namely ‘NRSRO’,

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[150] Chapter 2&3, ibid.
[151] Chapter 6 (Articles 38-44), ibid.
[152] Fanfu Meng [孟凡富], ‘The Licenses for Credit Rating Agency: An Analysis for 56 Credit Rating Agencies Completed Recordation [信用评级牌照 85: 56 家完成信用评级备案机构的分析]’ <https://zhuanlan.zhihu.com/p/216369271> accessed 10 October 2020.

which offered special market status to recognized CRAs. The regulatory licenses of NRSROs were offered to a certain number of CRAs for several decades. Since the approval of NRSRO, the credit ratings issued by NRSROs have been increasingly employed into the legislations, regulation and standards.

With the development of economic globalization, as mentioned above, European and other-region bond issuers were allowed to enter into the US bond market, and when they had positive credit ratings, they were more likely to obtain more capital in the bond market. This created large number of businesses for the US CRAs. Therefore, the US CRAs gradually occupy global market shares, especially in European market shares. At the same time, the Chinese bond market has not been formed. Therefore, the global CRAs has less effect on the Chinese CRA industry. Compared to the global financial crisis, the subsequent euro area crisis raises more significant concerns for the EU member states about the over-reliance on the foreign CRAs. This provides a strong political and economic motivations to encourage EU domestic or regional credit rating industry. In addition, China has been less affected by the financial crisis of 2008. Thus, the China regime of CRAs seems over-concise as the demand for regulation of CRAs is less than other two areas. It is because the history of Chinese CRAs is younger than that of the European Union and United States, that there are fewer unresolved problems than that faced by the other areas' jurisdictions.

More importantly, this chapter provides the wider social contexts with respect to CRAs in the European Union, United States and China, and these backgrounds contributes to understanding the three regions' various problems and their respective regulatory approaches to the same issue in the chapters that follow. In this Chapter, that the references to credit ratings of NRSROs were increasingly employed into the US legislations and regulations and standard, gave a clue to the severe regulatory over-reliance in the United States, as it will be discussed in Chapter 3. A small number of CRAs were approved in the United States for a long time and then entered in the global market during the economic globalization, which, from a historical perspective, addresses the oligopolistic market structure of the big three, as it will be discussed in Chapter 5. In addition, these specific problems provide various incentives for the three regions to regulate the CRAs. The United States more focuses on the regulatory reliance associated with the NRSRO. Given that the huge impact of the eurozone crisis, the European Union has the political motivations in dealing with the foreign CRAs issue, which will be observed from the EU regulatory approaches in the flowing chapters. Therefore, the European Union is driven by both economic and political motivations to better regulate CRAs. Given that the fewer unsolved problems, the demand for regulating CRAs seems less in China than that in other regions.

Chapter 3: Over-Reliance on Credit Rating Agencies

3.1 Introduction

CRAs were criticised during the global financial crisis of 2007–8 in two respects. One, was their over-reliance on credit ratings and the other was the rating quality. Taking as a starting position the post-crisis regulatory reforms of CRAs at the national, international and regional levels, this chapter critically analyses the over-reliance of investors and market participants on external credit ratings and the extent to which such a phenomenon was exacerbated by the use of credit ratings in legislation and regulatory frameworks. Chapter 3 is designed to answer the following questions related to the over-reliance: What is the over-reliance on credit ratings? Why is this overreliance considered to have exacerbated the global financial crisis, or even the financial stability? What are the existing regulatory approaches against the over-reliance? What is the implementation of such regulations? Are these regulatory approaches and implements effective enough to deal with the over-reliance? Otherwise, to what extent do these regulatory approaches and implements improve the situation respectively? Chapter 4, 5 and 6 aim to analyse the factors affecting the rating quality, namely the conflicts of interest, the oligopolistic market structure in credit rating industry and civil liability for CRAs.

In order to address these questions, this chapter, at first, addresses the common uses of credit rating in the legislation, regulations and standards. The widespread uses of credit ratings by regulators, investors, financial institutions and other market participants is the basis that credit ratings paly such a significant role in financial market. Second, it addresses a series of negative effects stemmed from rating downgrades, including rating triggers, cliff effects and systemic risks. Rating downgrades may trigger liquidity crisis and further cause the systemic risk of the whole financial market at national, regional and international level. The most important thing is the relation between the over-reliance and the financial stability. The Over-reliance not only exacerbates the liquidity problems but also results in financial disruptions. Third, it continues to address the existing regulations against the over-reliance in the US, EU and China and the implementation of such regulations.

3.2 The Basis for the Reliance on Credit Ratings

3.2.1 Historical Background

In the early part of the nineteenth century, the boom of US railroad bonds created a huge information asymmetry, which gave birth to the credit rating Industry. Specifically, before the expansion of railroad bonds, most transactions were conducted on the domestic level or even between people who know each other.[1] With the building of railroads all over the United States and the need for capital for these growing railroads, raising capital through local bank loans and bonds issuances in a small region for these railroad corporations were far from enough. Therefore, capital was beginning to be raised through railroad bonds across the country.[2] Meanwhile, faced with the increasing expansion of the bonds market, lenders and investors tended to pay attention to such railroad bond issuers with whom they had been unfamiliar. This created a huge demand for reducing the information asymmetry between investors and bond issuers. As a result, CRAs filled the gap. CRAs provided reports regarding the creditworthiness of such railroad bond issuers. Early in 1841, Lewis Tappan, the founder of Mercantile Agency, sold business information about the creditworthiness of American commercial enterprise;[3] and later, in 1890, Poor's Publishing Company provided comprehensive analysis about the business information of the railroad bonds.[4]

In 1909, John Moody, who set up Moody's Investors Services Inc. (hereafter 'Moody') later in 1914, issued Analyses of Railroad Investments,[5] which revolutionarily expressed business information of each railroad bond by classifying the creditworthiness of these bonds by way of alphabetical symbols;[6] for example, the rating of an 'A' letter indicated a high probability of repayment, while a 'D' meant a high probability of default. Gradually, the following CRAs adopted this successful alphabetical–symbol way of rating.

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[1] Francesco De Pascalis, *Credit Ratings and Market Over-Reliance: An International Legal Analysis* (Brill Nijhoff 2017) 15.
[2] Raquel García Alcubilla and Francisco Javier Ruiz del Pozo, *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (Oxford University Press 2012) Chapter 1.1.1.
[3] Nicola Jentzsch, *Financial Privacy: An International Comparison of Credit Reporting Systems* (2nd edn, Springer 2007) 63–4.
[4] Timothy J. Sinclair, 'Bond Rating Agencies' (2003) 8 New Political Economy 147.
[5] Moody's Investors Services Inc, 'Moody's History: A Century of Market Leadership' <https://www.moodys.com/Pages/atc001.aspx> accessed 15 February 2020.
[6] Emory R Johnson, 'Moody's Analyses of Railroad Investments by John Moody' (1909) 34 Annals of the American Academy of Political and Social Science 147.

There are two obvious advantages to this alphabetical-symbol rating of credit. First, the rating quality of various bonds is ranked by several rating scales, ranging from investment grade to speculative grade.[7] These credit ratings of various bonds provide more business information to market participants, so that market participants can understand the credit quality of various bonds, as well as the position of each bond in the whole market. Credit ratings play a role as information intermediary in the financial market, which essentially mitigates information asymmetry. Secondly, this kind of simple letter makes credit ratings easy to understand. Faced with large quantities of information in the financial market and various complex financial products, market participants are inclined to choose this simple but effective rating.

Simply put, the credit ratings were derived from the increasing need that mitigated the information asymmetry between bonds issuers and investors. The current way of rating credit is easily to understand and disseminate.

3.2.2 Theoretical Basis

The ground of market over-reliance on credit ratings is the role of credit rating in amelioration of information asymmetry. The following is the 'lemon' theory about the importance of mitigating information asymmetry for the whole market; in other words, mitigating information asymmetry helps the market maintain effective and stable. Akerlof put forward the 'lemon' theory, which explained information asymmetries through the used-car market: If every car in the market is either good or bad (a 'lemon'), the buyer of a new car cannot know whether the car is a good or bad until he/she purchases and uses it for some time.[8] We suppose that only the owner of the used car (seller) knows whether or not his/her car is good or bad, while the potential buyer does not. In other words, the seller now has more information regarding car quality than the buyer does and the information asymmetry is thus created. Furthermore, when buyers are unable to distinguish between good cars and bad cars ('lemon'), buyers may be more likely to offer the same price for both cars. Conversely, both good and bad cars have to be sold at the same price.[9] Consequently, the sellers of good cars cannot get fair offers. In short, the result of an information asymmetry

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[7] Investment grade includes A category (AAA, AA and A) to BB (the intermediate rating), while speculative grade includes B and other below ratings.
[8] George A Akerlof, 'The Market for 'Lemons': Quality Uncertainty and the Market Mechanism' (1970) 84 Quarterly Journal of Economics 3, 488.
[9] ibid.

may cause low-quality products, finally driving high-quality products out of the market, and the market may even collapse.

As mentioned above, the 'lemon' theory can be applied to the bond market. Bond issuers have more information about the quality of bonds, while lenders cannot know whether the issuers would be able to repay the debt until lenders own the bonds by the date of maturity. Owing to information asymmetries between bond issuers (borrowers) and lenders, the difficulty of selection is identified in the inability of the lenders to distinguish between high-risk bonds and low-risk bonds. Faced with a similar situation, lenders may also more likely offer the same interest rate to bond issuers (borrowers). As a result, the issuers of low-risk bonds have to pay the same interest rate as the issuers of high-risk bonds. Apart from that, there are other negative consequences caused by this information disequilibrium. For example, a certain number of borrowers who could have afforded a low interest rate, cannot raise capital from the bond market. Another example would be where lenders may lose confidence in the bond market due to the lack of sufficient information, and the whole capital market would shrink.

3.3 The Use of Credit Ratings

3.3.1 The Widespread Use of Credit Ratings in the United States

The first use of credit ratings for regulatory purposes dates back to 1930s in the United States. On the heel of the banking crisis in March 1931 and the Great Depression, US regulators attempted to strengthen investor protection. As a result, they decided to make a line to differentiate securities by their credit quality so that investors could avoid risky investments.[10] As a result, in 1936, the Office of the Comptroller of the Currency (hereafter 'OCC') categorised securities between investment grade and speculate grade by their credit ratings.[11] According to the relevant regulation of OCC, the bonds that financial institutions held had to be publicly rated at least BBB to be carried at book value; otherwise the bonds (rated below BB rating) should be written down to current market value and '50 percent of the resulting book losses were to be charged against capital'.[12] Later in 1936, the Office of

[10] Steven L Schwarcz, 'Private Ordering of Public Markets: The Rating Agency Paradox' (2002) 1 University of Illinois Law Review

[11] The OCC legally defined the 'investment securities' in section 5136 of Revised Status as Amended by the 'Banking Act of 1935'. Banking Act of 1935 (Public No. 305, 74th Congress, HR 7616).

[12] Richard R. West, 'Bond Ratings, Bond Yields and Financial Regulation: Some Findings' (1973) 16 The Journal of Law & Economics 159, 162.; see also Francesco De Pascalis (n 1) 37–8.

Comptroller of the Federal Reverse further enhanced the market status of CRAs by prohibiting financial institutions from holding bonds rated below BBB by two rating agencies.[13]

During the 1970s, one vital change incorporated credit ratings into the US rating-based regulation, namely the concept of NRSROs. On the heels of the collapse of Penn Central Transportation, the regulators aimed to enhance market confidence and maintain financial stability. At the same time, the growth of the credit industry and the function of credit rating service drew the attention of regulators. In 1973, the SEC created the NRSRO concept through amendments to Rule 15c3-1 of the Exchange Act, namely the Net Capital Rule. The Net Capital Rule specifically required broker-dealers to 'deduct from net worth certain percentage of the market value of their proprietary securities',[14] namely a 'haircut'. The 'haircut' was based on the risk characteristics of debt instruments held by broker-dealers.[15] If one debt instrument was rated at investment grade by one of two NRSROs, the broker-dealer could take a lower haircut.[16] This kind of regulatory approval granted a credible market status to NRSROS, which also triggered widespread use of credit ratings in more regulations.

Afterwards, credit rating, as regulatory tool, was extensively used in various sectors, including the banking sector, education sector, labour sector and the insurance sector. As Table 3.1 lists, a large number of regulations, such as the Securities Act of 1933[17] and the Investment Company Act of 1940, have incorporated the terms of NRSROs for regulatory purposes since the use of the Net Capital Rule. For example, in the late 1970s, credit ratings issued by NRSROs were applied by the US Department of Education to 'set standards of financial responsibility for institutions which want to engage in student financial assistance programs under Title IV of the Higher Education Act of 1965'. In another instance, section 3(a)(41) of the Exchange Act required 'mortgage-related security' to be 'rated in one of the two highest rating categories by at least one NRSRO'.

[13] Richard Cantor and Frank Packer, 'The Credit Rating Industry' (1994) 1 FRBNY Quarterly Review 1, 6.
[14] SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets' (2003) 6 <https://www.sec.gov/news/studies/credratingreport0103.pdf> accessed 20 April 2020.
[15] US General Government Division, *Regulatory and Industry Approaches to Capital and Risk* (1998) 132.
[16] SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets' (n 14).
[17] Regulation S-K (17 CFR 229.10); Rule 436 (17 CFR 230.436); Form S-3 (17 CFR 239.13); Forms F-2 and F-3 (17 CFR 239.32, 239.33). See SEC, 'Concept Release: Nationally Recognized Statistical Rating Organizations' (1994) Release No. 34-34616, File No. S7-23-94; <https://www.sec.gov/rules/concept/34-34616.pdf> accessed 2 April 2019.

Table 3.1 List of Rules and Regulations relating to NRSROs[18]

Rule or regulation	Detail
Securities Exchange Act of 1934 'Exchange Act' Rule 15c3-1[19] (enacted in1975)	This rule required broker-dealers to deduct percentages of their proprietary securities' market value when computing net capital. Nevertheless, reduced deductions are required for particular securities rated investment grade by at least two NRSROs.
Securities Exchange Act of 1934 'Exchange Act' Rule 10b-6[20] (adopted in 1975)	Exempts particular transactions in non-convertible debt and non-convertible preferred securities from Exchange Act provisions if the securities are rated investment grade by at least one NRSRO.
Investment Company Act of 1940 Rule 2a-7 [21] (enacted in 1975)	This rule requires money market funds to limit investments to 'eligible securities' that are rated in either of the top two short-term debt rating categories by the requisite number of NRSROs.
Federal Deposit Insurance Act Section 1831 (enacted in 1989)	Congress defines 'investment grade' corporate debt for savings associations as only securities rated in one of the four highest categories by at least one NRSRO.[22]
Investment Company Act of 1940 Rule 3a-7[23] (enacted in 1992)	Issuers of fixed-income securities rated in one of the top four rating categories by at least one NRSRO are exempted from registering and complying with the Investment Company Act. This rule also set out plenty of requirements to distinguish between investment companies and structured financing. Among these, the structured financings are required to be rated investment grade by NRSROs.

[18] Table adapted from Emily McClintock Ekins and Mark A Calabria, 'Regulation, Market Structure, And the Role of the Credit Rating Agencies' (2012) No.704 Policy Analysis <https://www.cato.org/sites/cato.org/files/pubs/pdf/PA704.pdf> accessed 29 September 2019. and SEC, 'Concept Release: Nationally Recognized Statistical Rating Organizations' (n 17) 3-6.

[19] 17 CFR 240.15c3-1, see SEC, 'SEC News Digest: A Daily Summary from the Securities and Exchange Commission' (1973) Issue 73-230 <https://www.sec.gov/news/digest/1973/dig112973.pdf> accessed 2 April 2019.

[20] 17 CFR 240.10b-6(a)(4)(xiii), see SEC, 'Concept Release: Nationally Recognized Statistical Rating Organizations' (n 17) 5.

[21] 17 CFR 270.2a-7.ibid.

[22] ibid.

[23] 17 CFR 270. 3a-7, see SEC, 'Exclusion from the Definition of Investment Company for Structured Financings' Release No.IC-19105; File No. S7-12-92 <https://www.sec.gov/rules/concept/1992/ic-19105.pdf> accessed 20 February 2020.

Rule or regulation	Detail
Investment Company Act of 1940 Rule 10f-3[24] (enacted in 1979)	This rule created a definition of municipal securities, and to be eligible as a municipal security, the debt instrument is required to be rated as investment grade by NRSROs.
Employee Retirement Income Security Act of 1974	Pension funds shall be partly based on credit ratings of their investment criteria on bond, and the credit ratings are required to be provided by NRSRO designated CRAs.
Retirement Income Security Act of 1974	Pension funds are mandated to be partly based on credit ratings of their investment criteria on bond and the credit ratings are required to be provided by NRSRO designated CRAs.
Secondary Mortgage Market Enhancement Act of 1984, section 3(a)(41) of the Exchange Act	*NRSRO* is used as a term to account for 'mortgage related security' which is required to be 'rated in one of the two highest rating categories by at least one NRSRO.[25]
Federal Deposit Insurance Act of 1989	Company debt securities is required to be rated on one of the four highest categories at least one NRSRO.[26]
Investment Company Act of 1940 Rule 2a-7 (enacted in 1991)	Less than 5 percent of money market mutual fund assets may be invested in commercial paper that NRSROs assign lower than the first or second highest grade.
Simplification of Registration Procedures for Primary Securities Offerings, Securities Act 1992	Credit ratings issued by NRSROs are applied to distinguish between different types of securities that may be issued using simplified registration procedures.

In short, the regulatory use of credit rating in US legislation can be dated back to the Banking Act of 1936. Later in 1970s, the SEC conferred a special market status on NRSROs through the Net Capital Rule. As the Net Capital Rule paved the way to the widespread use of credit ratings in regulations and rules, the US rating-based regulatory framework, ranging from banking regulation to labour and insurance regulation, gradually formed.

[24] 17 CFR 270.10f-3, see SEC, 'References to Ratings of Nationally Recognized Statistical Rating Organization' (2008) Release Nos. IC-28327; IA-2751 File No. S7-19-08, 22-3 <https://www.sec.gov/rules/proposed/2008/ic-28327.pdf> accessed 20 February 2020.
[25] SEC, 'Concept Release: Nationally Recognized Statistical Rating Organizations' (n 17) 3.
[26] ibid.

3.3.2 The Regulatory Use of Credit Ratings in the European Union, China and United States

Credit ratings are broadly used in the European Union, China and other countries. At international level, credit ratings are used in regulation and rules for three or four main purposes: (i) to determine capital requirement; (ii) to identify permissible assets, usually in the context of eligible investments or permissible asset concentration; (iii) to provide an evaluation of credit risk when securities or covered bond offering; and (iv) to determine disclosure requirements and prospectus eligibility.[27] In China, according to the report issued by the PBO in 2013, the regulatory use of credit ratings manifests in determining capital requirement for commercial banks, insurance and reinsurance, and for securitisation and corporate bond offerings.[28]

a. Capital Requirement

The primary use of external credit ratings is to determine the regulatory capital, especially in the pillar I 'Minimum Capital Requirements' of the Basel II framework.[29] The European Union, United States and China have incorporated this framework into their respective regulatory systems, and the external credit ratings can be used to determine regulatory capital requirements and set capital models for credit risk among these areas.

The calculation of capital requirement considers various forms of risk. Among them, credit risk is the major component for commercial banks, while market risk is more significant for investment banks and securities firms. External credit rating can be regarded as a primary determinant of the quality of risk-weighted assets which is used to determine the credit risk. This process is similar to the calculation of market risk for debt securities. As a result, the credit rating directly affects the determination of capital requirements.[30]

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[27] Basel Committee on Banking Supervision (The Joint Forum), 'Stocktaking on the Use of Credit Ratings' 3–4 <https://www.bis.org/publ/joint22.pdf> accessed 1 January 2020.
[28] Xiangdong [向东] Zhang [章], 'Research on the test of Credit Rating Quality in China [我国信用评级质量检验报告]' (PhD Thesis, University of International Business and Economics [对外经贸大学] 2015).
[29] Rolf H. Weber and Aline Darbellay, 'The Regulatory Use of Credit Ratings in Bank Capital Requirement Regulations' (2008) 10 Journal of Banking Regulation 1, 4.
[30] Iain G MacNeil, 'Credit Rating Agencies: Regulation and Financial Stability' in Thomas Cottier and Others (eds), *The Rule of Law in Monetary Affairs: World Trade Forum*, 186 (Cambridge University Press 2014).

The European Union implemented the Basel III framework for both banks and investment firms through Capital Requirements Directive IV.[31] In the United States, credit ratings are most extensively used in the determination of capital requirements in both the banking and securities sectors. At the same time, NRSROs are exclusively eligible to issue credit ratings for the purpose of capital requirements.[32]

Like the European Union and United States, under the Basel framework, the broadest regulatory application of credit rating in China is to determine capital requirements. In 2012, the CBRC issued the Administrative Measures for the Capital of Commercial Banks[33], which provides the existing rating-based regulation in the banking sector, especially for commercial banks, There are two aspects in this regulation relating to the reliance on external credit rating: (i) the external credit ratings are used to calculate the credit risk of risk-weighted assets and risk-weighted assets for the securitisation exposures; and (ii) commercial banks should refer to external credit ratings when classifying eligible liquid assets.

b. Asset Identification

Credit ratings are used to 'determine permissible assets and/or required investments for mutual funds, as well as the concentration limits for particular types of assets'.[34] In the United States, the extensive rating-based regulation for asset identification purposes occurs in the banking and securities sector, including money market funds.[35] In addition, many state insurance laws control permissible assets and/or concentration limits with reference to credit ratings.[36] in the European Union, the Undertakings for Collective Investment in Transferable Securities Directives[37] on collective investment schemes does not refer expressly to credit ratings. Nevertheless, Articles 6 and 10 of Commission Directive 2007/16/EC do refer the

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[31] The CRD consist of Directive 2013/36/EU on access to the activity and the prudential supervision of credit institutions and investment firms (Capital Requirements Directive IV) (OJ 2013 L 176) recital 79.
[32] 17 CFR 240.17g-1 – 240.17g-6 and Form NRSRO. See Basel Committee on Banking Supervision (The Joint Forum) (n 27) 5.
[33] China Banking Regulatory Commission [中国银监会], 'Administrative Measures for the Capital of Commercial Banks (for Trial Implementation) [《商业银行资本管理办法》（试行）]' No. 1 [2012] of the China Banking Regulatory Commission.
[34] Basel Committee on Banking Supervision (The Joint Forum) (n 27) 7.
[35] 17 CFR 270.2a-7, setting out the risk-limiting provisions applicable to money market funds. See MacNeil (n 30) 186.
[36] Basel Committee on Banking Supervision (The Joint Forum) (n 27) 7–8.
[37] This framework is contained in Commission Delegated Regulation (EU) 2018/1619 of 12 July 2018 amending Delegated Regulation (EU) 2016/438 as regards safe-keeping duties of depositaries (OJ 2018 L271).

credit ratings in their definition of permissible assets.[38] Notice of the China Insurance Regulatory Commission on Issuing the Interim Measures for the Investment of Insurance Funds in Bonds (hereafter 'Notice of CIRC')[39] can be regarded as a clear example in the insurance sector. Article 9(1)3&4 of Notice of CIRC requires insurance funds to invest in corporate bonds with least AA ratings issued by domestic CRAs or with BB and above ratings issued by international CRAs.

c. Securitisation and Covered Bonds Offering[40]

In general, the rating-based regulation regarding the securitisation requires that securitisations be rated by at least one CRA for investors.

The development of securitisation, such as asset-backed securitisation, in various areas is significantly uneven. In China, the Notice of PBOC, the China Banking Regulatory Commission and the Ministry of Finance on Relevant Matters Concerning Further Expanding the Pilot Securitization of Credit Assets (hereafter 'FEPSCA')[41] requires that the structure of credit asset securitisation products shall be simple and clear and, therefore, the re-securitisation or synthetic securitisation in the expanded pilot stage shall not be allowed.

As a result, there are not many relevant provisions in China. Article 4 of FEPSCA provides that securitisation should be rated by two approved CRAs when it is issued in the interbank market. However, when securitisation is issued on other platforms, such as the Shanghai Exchange and Shenzhen Exchange, credit rating is not a compulsory requirement.[42]

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[38] Raquel García Alcubilla and Francisco Javier Ruiz del Pozo (n 2) 17.

[39] China Insurance Regulatory Commission [中国保监会], 'Notice of the China Insurance Regulatory Commission on Issuing the Interim Measures for the Investment of Insurance Funds in Bonds [保险资金投资债券暂行办法]' (2012) No. 58 [2012] of the China Insurance Regulatory Commission <保监发〔2012〕58 号>.

[40] Securitisations mainly refers to the process of pooling assets and issuing securities representing interest in the pool of asserts. Covered bonds are debt instruments issued by banks and other credit institutions, the repayment of which is secured by a ring-fenced pool of assets backing the bond. See Basel Committee on Banking Supervision (The Joint Forum) (n 27) 8.

[41] People's Bank of China, Ministry of Finance and China Banking Regulatory Commission, 'Notice of the People's Bank of China, the China Banking Regulatory Commission and the Ministry of Finance on Relevant Matters Concerning Further Expanding the Pilot Securitization of Credit Assets [中国人民银行、中国银行业监督管理委员会、财政部关于进一步扩大信贷资产证券化试点有关事项的通知]' (2012) No. 127 [2012] of the People's Bank of China (银发[2012]127 号].

[42] Many provisions state that as credit rating report is a voluntary requirement, and issuer is not required to compulsorily provide it. See in Article 6 of Guidelines on Information Disclosure of Asset Securitization Business of Securities Companies and Fund Management Companies' Subsidiaries [证券公司及基金管理公

However, credit rating is an indispensable tool during the creation of securitisation, because the credit ratings are used to identify and tranche the underlying assets of the structured financial products, as it will be discussed below in the Chapter 4, and so far, no alternative has been found. Following these regulations, the banks still utilise credit ratings to design and create securitised financial products.[43] Even though these regulations do not regard credit rating as a compulsory element, the market still relies on credit ratings to access the credit risk of assets and identify them in different tranches. The United Kingdom determines the credit quality of securitisation through ratings by the external credit assessment institution. In terms of covered bonds, it also considers the quality of asset pool by whether or not the counterparty has an appropriate credit rating.[44] In contrast, in the United States, a large number of banking and securities regulations and rules governing asset-backed instruments refer to external credit ratings.[45]

d. Prospectus Rules

External credit ratings are often used as part of prospectus requirements in the context of securities offering. In the United States, the SEC has a large amount of rating-based regulation in the context of prospectus requirements. Credit rating is used in the short-form prospectus in securities offering.[46] In the United Kingdom, in the bond market, issuers must disclose credit ratings in the prospectus.[47] In China, there are plenty of rating-based regulations and rules in the context of securities offering. For example, on the stock exchange, Article 6 of the Guidelines of the Shenzhen Stock Exchange for the Issuance of

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司子公司资产证券化业务信息披露指引] (No. 49 [2014] of the China Securities Regulatory Commission [证监发[2014]49 号]).; Appendix 1 of the Shanghai Stock Exchange, 'Notice of the Shanghai Stock Exchange on Issuing and Implementing the Business Guidelines of the Shanghai Stock Exchange on Asset Securitization [上海证券交易所资产证券化业务指南]' (2014) No. 80 [2014] of the Shanghai Stock Exchange [上证发[2014]80 号].; Article 9 (6) of Shenzhen Stock Exchange, 'Notice of the Shenzhen Stock Exchange on Issuing the Business Guidelines of the Shenzhen Stock Exchange for Asset Securitization [深圳证券交易所资产支持证券挂牌条件确认业务指引]' (2014) No. 49 [2014] of Shenzhen Stock Exchange [证监会公告〔2014〕49 号].

43 Yujie Xu [许余洁] and Bowen Deng [邓博文], 'The Risk Analysis of Chinese Enterprise Asset Securitisation Market and Credit Rating [我国企业资产证券化市场的风险分析与信用评级关注]' (2017) 2 Jin Rong Fa Yuan [金融法苑] 109.

44 Basel Committee on Banking Supervision (The Joint Forum) (n 27) 8.

45 ibid.

46 17 CFR § 239.13—Form S-3 (for registration) of Securities Act of 1933 (as amended through PL 112-106, approved April 5, 2012, 15 USC § 77a).

47 Article 100-bis, part 4 of Consolidated Law on Finance pursuant to Articles 8 and 21 of Law no. 52 of 6 February 1996 (Legislative Decree No. 58 of 24 February 1998).

Securities by Bidding[48] requires issuers of corporate bonds to be rated at least triple A before these bonds can be issued on the Shenzhen Exchange. Another example is found in the interbank market, where the issuer of securities must be rated above an AA rating.

3.4 The Negative Effects of Over-reliance on Credit Ratings

3.4.1 Rating Downgrades and Rating Trigger Clauses

Rating downgrades and rating trigger clauses exacerbate liquidity problems. A rating downgrade has a signalling effect in the financial market. Rating downgrades not only reflect some information of a rated entity, but also conveys information to the financial market, and investors usually react to these rating changes.[49] Rating downgrades are usually regarded as a negative signal to convey the information on the deterioration of the borrower's creditworthiness.[50] Based on this, the possible response for investors is not to invest or to stop holding these downgraded securities.[51] As a result, the rating downgrade escalates the borrower's liquidity situation.

Rating trigger clauses are widely used in the bond indentures and in financial contracts.[52] Once the rating downgrades go below a given threshold, the duty on the borrower will be activated and the lender has the enforceable right to impose on the borrower a specific action in accordance with the context in the agreements.[53] Rating trigger clauses are designed not only to protect lenders against borrower credit deterioration, but also to reduce the cost of borrowing capital.[54] There are three common types of rating triggers clauses: (i) collateral, letter of credit and bonding provisions; (ii) pricing grids or adjustments in interest rates or coupons; (iii) acceleration clauses.[55] First, the collateral, letter of credit and bonding provisions are often included in bank loan agreements. In the event of a rating downgrade,

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48 Guidelines of Shenzhen Stock Exchange for the Issuance of Securities by Bidding《深圳证券交易所债券招标发行业务指引》 2017 (No. 119 [2017] of the Shenzhen Stock Exchange [深圳会〔2017〕119 号]).

49 Claire A. Hill, 'Regulating the Rating Agencies' (2004) 82 Washington University Law Quarterly, 68.

50 Aline Darbellay, *Regulating Credit Rating Agencies* (Edward Elgar Publishing Limited 2013) 183.

51 ibid.

52 Federico Parmeggiani, 'Rating Triggers, Market Risk and the Need for More Regulation' 14 European Business Organization Law Review, 428.

53 ibid.

54 Francesco De Pascalis, *Credit Ratings and Market Over-Reliance: An International Legal Analysis* (Brill Nijhoff 2017) 46.

55 Fernando Gonzalez and others, 'Market Dynamics Associated with Credit Ratings: A Literature Review' European Central Bank, Occasional Paper Series No.16, 13-4 <https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp16.pdf> accessed 10 October 2020.

the borrower is required to pledge assets to guarantee it financing over time.[56] Second, pricing grids or adjustments in interest rates or coupons are often written into both bonds and bank loan agreements. The initial interest rate or coupon will be revised once the clause is triggered.[57] Third, acceleration clauses may result in an acceleration of repayments or even early termination of credit when these clauses are activated.[58] Among these types mentioned, the acceleration clauses have the most severe, or even critical impacts upon liquidity problems, because it may result in not only an increase in the cost of capital, but also in an immediate need for new capital.[59]

Even though these clauses do not apply to CRAs directly, a rating downgrade is the key to activate these rating trigger clauses. Rating trigger clauses also have negative effects on the financial market. Besides this negative effect of the rating downgrade itself, once rating downgrades activate these rating trigger clauses, the borrower's liquidity problems will be further exacerbated. When the company (borrower) is incapable of coping with the liquidity problem, eventually, it is often faced with insolvency.[60] To sum up, when a rating is downgraded, it reflects the poor performance of the downgraded company in some aspects and, at the same time, the signalling of a rating downgrade increases the cost of capital for the issuer. In addition, the possible subsequent ratings trigger further worsens the liquidity problem of the issuer.

As a result, the interconnectedness of rating downgrades and rating triggers has a cascading impact on problems of liquidity.

3.4.2 Credit Cliff Effect, Herding Behaviours and Rating-based Regulation

Having illustrated the negative effects of rating downgrades and rating triggers on liquidity problems, the question becomes how rating downgrades eventually lead to a liquidity crisis. In addition, the 2007 financial crisis brought to attention the 'hardwiring' of credit ratings into legislation and regulatory frameworks. What is the role of the 'hardwiring' of credit ratings in the liquidity crisis?

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[56] ibid 13.
[57] ibid 13-4.
[58] ibid 14.
[59] ibid.
[60] Francesco De Pascalis (n 1) 47.

Rating downgrades and rating triggers probably contribute to a credit cliff situation. A credit cliff effect indicates numerous sell-offs of debt instruments in the event of one substantial rating downgrade.[61] Specifically, when a rating drops below a certain level, in conjunction with the effects of rating triggers, large numbers of holders of relevant securities are likely to sell such securities in case of a rapid decline of securities price and possible liquidity problems.[62] A credit cliff effect is often amplified by the herding behaviours of investors. *Herding behaviours* here means that investors tend to mimic investment behaviours of other investors.[63] These selloffs caused by the credit cliff effect may be further escalated by other investors due to herding behaviours.

The Over-reliance on credit ratings, especially rating-based regulations further amplifies these negative effects caused by the rating downgrades. The over-reliance on credit ratings is a cause of cliff effects, because rating-based regulation and standards exacerbate the negative effects of rating downgrades. References to credit ratings in the legislations, regulations and standards reinforce the market over-reliance on credit ratings, which amplifies the *procyclicality* through the cliff effect.[64] For credit ratings, *procyclicality* refers to rating inflation in good times and massive rating downgrades in bad times. Without rating-based regulation, a sell-off of investors affected by a rating downgrade of owned securities may be an autonomous response. Under rating-based regulation, this response could be more regarded as a constrained behaviour, because securities holders have to sell the speculative-grade securities after a rating downgrade when there is a rule requiring these holders to only hold investment-grade securities.[65] As discussed above, there are a large number of regulations and rules associated with permissible assets identification by credit ratings. For example, owing to the rating-based capital requirements, when downgraded, banks were required to adjust their risk-weighted capital requirement upwards.[66] In addition, the rating-based rules associated with permissible assets identification require many banks and investors to invest and hold assets rated above a particular level. Once the rating drops below the required level, the investors have to sell such assets, which exacerbates the impacts of a

[61] European Commission, 'Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (Ec) No. 1060/2009 on Credit Rating Agencies' (2010) SEC (2010) 13.
[62] Iain G MacNeil, 'Credit Rating Agencies: Regulation and Financial Stability' in Thomas Cottier and Others (eds), *The Rule of Law in Monetary Affairs: World Trade Forum* (Cambridge University Press 2014) 189–190.
[63] See Avinash Persaud and State Street, 'Sending the Herd off the Cliff Edge: The Disturbing Interaction Between Herding and Market Risk Sensitive Risk Management Practices' [2000] BIS Papers No. 2 233, 235 <https://www.bis.org/publ/bppdf/bispap02l.pdf> accessed 28 February 2020.
[64] *Procyclicality* refers to escalation of market trends in financial market. See Aline Darbellay (n 50) 186.
[65] Francesco De Pascalis (n 1) 55.
[66] Aline Darbellay (n 50) 188.

rating downgrade. In addition, the over-reliance on credit rating is also a cause of herding behaviours, when regulations require or motivate numerous market participant to act in an almost identical fashion in the event of a rating downgrade.[67]

3.4.3 Systemic Risk

As can be seen from the analysis above, rating downgrades and a series of other negative events arising from these downgrades exacerbate the liquidity problems. Besides a liquidity crisis, rating downgrades may result in systemic disruptions through credit cliff effects.[68] This section will address how with the impetus of credit ratings, the liquidity problem transmits throughout the whole financial system. In addition, it will address how the over-reliance on credit ratings amplifies systemic risk.

As shown in recent financial crises, the liquidity problems were transmitted in the chain of financial institutions and further triggered systemic risk. The systemic risk stemmed from rating downgrades with two preconditions. The first is the oligopolies of the big three CRAs in the rating market. More accurately, the CRA that issued the credit rating should have a certain influence on the market, and the oligopolistic market structure of the big three fulfils the criterion. Second, the downgraded entity has a certain magnitude in the market. For example, the Greek sovereign rating downgrade gave rise to the euro area crisis.

Rating downgrades have a systemic effect on the whole market through its spill-over effects. For example, If a big insurance company like American International Group, a largest global insurance corporation with more than USD 1 trillion dollars in assets prior to the financial crisis[69], was downgraded, the assets that it has insured will subsequently be downgraded as well.[70] This market contagion accentuates the effects of rating downgrades. In addition, the spill-over effects of rating downgrades can spread from a domestic to regional level, and even to the global level. Sovereign rating downgrades transmit a spill-over impact on domestic financial institutions and bond markets across financial markets. For instance, four main Portuguese financial institutions were downgraded after the sovereign downgrade of

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[67] Financial Stability Board, 'Principles for Reducing Reliance on Credit Ratings'1 <https://www.fsb.org/wp-content/uploads/r_101027.pdf> accessed 20 May 2020.
[68] ibid.
[69] Joel Ario and Peter A. Wayland, 'AIG's Impact on the Global Economy: Before, During and After Federal Intervention', *The AIG Debacle: Global Impact and the Need for Government Intervention* (Nova Science Publishers 2010) 2-7.
[70] Aline Darbellay (n 50) 191.

Portugal.[71] The Italian sovereign downgrade in 2011 gave rise to downgrades of the main companies in the country.[72] A further example is S&P's downgrade of Greek sovereign debt near to speculative grade which triggered the following downgrades of other European countries and instability of euro zone countries. [73] It seems evident that rating downgrades have a systemic effect on the whole financial market beyond the national level.

This kind of systemic effect of credit ratings is amplified by over-reliance through the following factors: First, the development of risk transfer techniques created a misconception about measuring actual risks within a financial system. Individual risk was transferred by various and novel risk transfer techniques, such as credit default swap (hereafter 'CDS'). In fact, the risk transfer techniques cannot reduce the risk but transfers individual risk to others. Furthermore, this posed a greater risk to the whole financial market. Most importantly, credit ratings are applied in the creation of the risk transfer techniques,[74] which presents the over-reliance on credit ratings by the market in one respect.

Second, the regulatory capital requirement associated with credit ratings further reinforces financial instability. When the price of financial instruments drops, investors tend to choose to sell in order to reduce loss. Under some relevant regulatory capital requirements or rating-based rules that require financial institutions only to hold permissible assets, the chance is bigger that financial institutions would sell such financial instruments at the time when the price declines; [75] in other words, the over-reliance on credit rating exacerbates the implications of a rating downgrade and further destabilises the financial system.

Third, the over-reliance on credit ratings rather than the credit rating itself causes a series of systemic disruptions. First, credit ratings are used to reduce the information asymmetry, but it cannot be regarded as a type of information disclosure because credit rating is an opinion based on processed information. This opinion cannot be verified as being true or false; which is to say, the possibility of inaccuracy of a credit rating should be considered by the financial

[71] Reuters Staff, 'Portugal Banks Cut after Sovereign Downgrade' *Reuters* (Lisbon, 14 July 2010) <https://www.reuters.com/article/portugal-moodys-banks/portugual-banks-cut-after-sovereign-downgrade-idUSLDE66D1GW20100714> accessed 18 March 2020.
[72] Bertrand Candelon and Amadou NR Sy Rabah Arzeki, 'Sovereign Rating News and Financial Markets Spill-Overs: Evidence from the European Debt Crisis' (2011) WP/11/68 International Monetary Fund <https://www.imf.org/external/pubs/ft/wp/2011/wp1168.pdf> accessed 18 March 2020.
[73] ibid.
[74] As addressed early on in Chapter 2, credit rating is used as a tool to classify underling assets during the process.
[75] MacNeil (n 30) 193.

market.[76] Admittedly, credit ratings with errors will accentuate the negative effects stemming from the rating downgrades on the financial stability. However, it should be noted that even if assuming credit rating does not contain errors (even though it is inevitable that there are some errors in credit ratings in practice), rating downgrades still have the capability to cause cliff effects.[77] This also supports the argument that the over-reliance on credit ratings instead of the credit rating itself is the root of financial instability. Inaccurate credit ratings may contribute to many more risks in financial markets, such as systemic risk. The root of the inaccuracy of credit ratings is that credit ratings are deemed to be more of an opinion or an evaluation that reflects an uncertain possibility. Compared to credit rating, disclosure, as another common tool for reducing information asymmetry, is applied to reflect relevant facts that can be verified or falsified.

Simply put, rating downgrades and the consequent negative effects exacerbate the liquidity crisis and, ultimately, affects financial stability. All of the negative implications demonstrated above drew attention to the danger of over-reliance on credit ratings. Over-reliance on the credit ratings aggravates rating downgrades and exacerbates the risks to financial stability. Regulators and policymakers began to realise and rethink the tie between the risks, such as liquidity risk and systemic risk, and rating-based regulation. The following section will address the current regulatory approach against the over-reliance.

3.5 The Current Regulatory Approaches Against the Over-reliance on Credit Ratings

3.5.1 The United States Regulatory Approach

Leading up to the financial crisis of 2007-8, the SEC did not realize the potential problems deriving from the over-reliance, even though there had been two regulatory discussions regarding regulatory use of credit ratings before, namely SEC Release No. 34-34616 of 1994 (hereafter '1994 Release')[78] and SEC Release No 34-47972 of 2003 (hereafter '2003 Release')[79]. Under the 1994 Release, the SEC analysed the regulatory uses of credit ratings and discussed the formalized process for approving NRSROs.[80] Even though the NRSROs

[76] ibid 189.
[77] ibid 189-90.
[78] SEC, 'Concept Release: Nationally Recognized Statistical Rating Organizations' (n 17).
[79] SEC, 'Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws' Release Nos. 33-8236; 34-47972; IC-26066; File No. S7-12-03 <https://www.sec.gov/rules/concept/s71203/mbsturmfelz120503.pdf> accessed 2 April 2019.
[80] SEC, 'Concept Release: Nationally Recognized Statistical Rating Organizations' (n 17).

as a regulatory tool were widely used in financial regulations, the term of NRSRO was not defined at that time.[81] Afterwards, a 1997 release[82] proposed to provide a specific definition of NRSROs, but the SEC did not adopt the proposal.[83] At the start of the twenty-first century, some credit rating scandals, namely those involving Enron and WorldCom, gave rise to a debate on the role of CRAs in both financial regulation and the markets. In 2003, the SEC considered the role of CRAs in the financial legislation in many aspects, ranging from conflicts of interest stemming from issuers-pay model to the lack of accountability of CRAs.[84] Compared with the 1994 Release, one apparent change in the 2003 Release is that the SEC realized the potential risks stemming from the reliance on CRAs. However, like the 1994 Release, the 2003 Release still did not explicitly indicate the hardwiring between credit ratings and financial regulation, and lacked acknowledgement of the danger of over-reliance on credit ratings.

Later in 2008, the Release of No 34-58070[85] (hereafter ‘2008 Release’) began to discuss the danger posed by the rating-based rules and the possibility of the elimination of rating-based rules and legislation from the existing regulatory framework.[86] In order to address the effect of over-reliance on credit ratings, the 2008 Release discussed whether and to what extent investors rely on rating-based rules when they make investment decisions. Even though this approach targeted a reduction in the undue reliance on credit ratings, it remained unknown whether the SEC was able to verify and distinguish which rating-based rules caused undue reliance.[87] Consequently, the rating-based regulations were still the significant component of the US regulatory framework in the aftermath of the 2008 Release.[88]

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[81] SEC, ‘Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets’ (n 14) 11.
[82] SEC, ‘Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934’ (1997) Release No. 34-39457; File No. S7-33-97 <https://www.sec.gov/rules/proposed/34-39457.txt> accessed 20 February 2019.
[83] SEC, ‘Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets’ (n 14) 15.
[84] SEC, ‘Concept Release: Request for Comment on Nasdaq Petition Relating to the Regulation of Nasdaq-Listed Securities’ (2003) Release No. 34-47849; File No. S7-11-03 <https://www.sec.gov/rules/concept/34-47849.htm> accessed 2 April 2019.
[85] SEC, ‘References to Ratings of Nationally Recognized Statistical Rating Organization’ (2008) Release No 34-58070, File No s7-17-08 <https://www.sec.gov/rules/proposed/2008/34-58070fr.pdf> accessed 20 April 2020.
[86] ibid 40089.
[87] Francesco De Pascalis (n 1) 79.
[88] The 2008 Release just targeted to the specific issues related to part of rating-based rules, see SEC, ‘References to Ratings of Nationally Recognized Statistical Rating Organization’ (n 85) 40089.

Until Dodd–Frank Wall Street Reform and Consumer Protection Act 2010 (hereafter 'Dodd–Frank Act') in 2010[89], section 939A finally dealt with the regulatory source of over-reliance on credit ratings, namely the hardwiring of credit ratings in financial regulation.[90] In great detail, section 939A requires all US regulators to review each rating-based rule in their respective regulations and remove those rating-based rules that induce uncritical reliance on external credit ratings and to replace them with alternative standards.[91]

This rule (section 939A) is based on the rationale that: (i) investors misconstrue the credit rating issued by NRSROs as 'a stamp of approval', and they therefore fail to carry out their due diligence; (ii) this laxness of credit risk assessment may lead to irrational investment decisions; and (iii) section 939A is thus designed to cease the external rating reliance of investors through eliminating governmental use of credit ratings.[92] In addition, section 939B of the Dodd–Frank Act eliminates NRSRO's exemption from Regulation on Fair Disclosure (hereafter 'Regulation FD')[93].[94] The reasons why credit ratings were once exempted by the SEC from Regulation FD is that CRAs were not involved in incidents of selective disclosure and the credit ratings, including the process and result, are publicly available.[95] Even though the eliminated exemption of Regulation FD for credit ratings is unable to make the non-public information equally available to all the rating agencies, this regulation at least reduces regulatory privileges. In short, section 939 A is a revolutionary change in US financial regulation. Section 939A of the Dodd–Frank Act not only requires ending the hardwiring of credit ratings in US legislation between US regulators and credit ratings, but also attempts to change the exclusive role of CRAs in the market.

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89 Dodd–Frank Wall Street Reform and Consumer Protection Act 2010 (Public Law 111-203, 111th Congress).
90 SEC, 'Section 939: Credit Rating Agencies' <https://www.sec.gov/spotlight/dodd-frank-section.shtml#939> accessed 20 April 2020.
91 SEC, 'Report on Review of Reliance on Credit Ratings' (2011) 1 <https://www.sec.gov/files/939astudy.pdf> accessed 20 April 2020.
92 US Housing Hearing 112 Congress, 'Oversight of the Credit Rating Agencies Post Dodd–Frank' (2011) <https://www.govinfo.gov/content/pkg/CHRG-112hhrg67946/html/CHRG-112hhrg67946.htm> accessed 23 April 2020.
93 Regulation Fair Disclosure is subject to 'the selective disclosure of information by publicly traded companies and other issuers.' Regulation FD requires issuers to make the fair and full disclosure to the public, 'when the issuers disclose material nonpublic information to a certain individuals and entities stock analysts, or holders of the issuer's securities who may well trade on the basis of such information.' See SEC, 'Fast Answers: Fair Disclosure, Regulation FD' (2014) <https://www.sec.gov/answers/regfd.htm> accessed 20 July 2018.
94 Section 939B of the Dodd-Frank Act
95 SEC, 'Final Rule: Selective Disclosure and Insider Trading' (2000) Release Nos. 33-7881, 34-43154, IC-24599, File No. S7-31-99 RIN 3235-AH82 <https://www.sec.gov/rules/final/33-7881.htm> accessed 25 May 2020.

In terms of the implementation of section 939A for the regulatory use for asset identification, most relevant regulations have literally removed the reference to credit ratings. [96] According to Table 3.2 listed regulations by the US federal agencies have completed the removal mandated by section 939A. However, these implementations merely reached facial compliance with section 939A. For one thing, as can be seen from the many revised rules in Table 3.2, these regulations just remove the 'letters' of credit rating, but they do not put in place any effective alternative to the previous provision. For example, the CFTC deleted section 1.49, but it does not provide any alternative to the previous standard. A further example is the OCC provides a materially similar phrase, namely the 'issuer has an adequate capacity to meet financial commitment' to replace the previous expression 'the issuer or instrument is rated investment grade by an internationally recognized rating organization'. The OCC also explains the 'adequate capacity' that 'the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected'. The SEC noted that funds could continue to rely on credit rating to consider external factors as part of the ongoing monitoring process, given the fact that 'a fund adviser's obligation to monitor risks to which the fund is exposed would, as a practical matter, require the adviser to monitor for downgrades by relevant credit rating agencies'.[97] Which is to say, in the absence of an effective alternative, regulated parties can still rely on the credit ratings where they deem appropriate; in the presence of an effective alternative to credit rating, regulated entities have freedom to choose.

Table 3.2 the Comparison of Rating-Based Regulations pre and post the Dodd- Frank Act[98]

Regulator	Pre Dodd–Frank Act	Post Dodd–Frank Act
Commodities Futures Trading Commission (CFTC)	17 CFR § 1.49(d)(3)(i)(B) requires bank or a trust company located outside the United States 'whose commercial paper or long-term debt instrument or, if a part of a holding company system, its holding company's commercial paper or long-term debt instrument,' to be	This 17 CFR § 1.49(d)(3)(i)(B) provision has been removed. However, it does not provide any alternative.

[96] Zachary Mollengarden, 'Credit Ratings, Congress, and Mandatory Self Reliance' (2018) 36 Yale Law & Policy Review, 506 <https://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=1728&context=ylpr> accessed 10 February 2020.
[97] SEC, 'Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule' 7 CFR Parts 270 and 274, Release No. IC-31828; File No. S7-07–11, 30 <https://www.sec.gov/rules/final/2015/ic-31828.pdf> accessed 5 May 2020.
[98] Table adapted from Zachary Mollengarden (n 96) 487-92.

Regulator	Pre Dodd–Frank Act	Post Dodd–Frank Act
	rated in one of the two highest rating categories by at least one NRSRO.	
Office of the Comptroller of the Currency (OCC)	12 C.F.R. § 28.15(a)(1)(iii) required that a foreign bank's capital deposits must consist of: 'Certificates of deposit, payable in the United States, and banker's acceptances, provided that, in either case, the issuer or the instrument is rated investment grade by an internationally recognized rating organization, and neither the issuer nor the instrument is rated lower than investment grade by any such rating organization that has rated the issuer or the instrument.'	12 C.F.R. § 28.15(a)(1)(iii) required that a foreign bank's capital deposits must consist of: 'Certificates of deposit, payable in the United States, and bankers' acceptances, provided that, in either case, the issuer has adequate capacity to meet financial commitments for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.'
National Credit Union Administration (NCUA)	12 C.F.R. § 703.8(b)(3) provides that 'if the broker-dealer is acting as the Federal credit the union's counterparty, the ability of the broker-dealer and its subsidiaries or affiliates to fulfil commitments, as evidenced by capital strength, liquidity, and operating results, the Federal credit union should consider current financial data, annual reports, reports of nationally-recognized statistical rating organizations, relevant disclosure documents, and other sources of financial information.'	12 C.F.R. § 703.8(b)(3) provides that 'If the broker-dealer is acting as the Federal credit union's counterparty, the ability of the broker-dealer and its subsidiaries or affiliates to fulfil commitments, as evidenced by capital strength, liquidity, and operating results. The Federal credit union should consider current financial data, annual reports, external assessments of creditworthiness, relevant disclosure documents, and other sources of financial information.'
Federal Housing Finance Agency **(**FHFA**)**	12 C.F.R. §1267.3(a)(3)(ii) provides that a bank may not invest in debt instruments that are rated below investment grade except when 'debt instruments that had been downgraded to a below investment grade rating after acquisition by the Bank'.	12 C.F.R. §1267.3(a)(3)(ii) provides that a bank may not invest in debt instruments that are not investment quality, except when debt instrument that a Bank determined became less than investment quality because of developments or events that occurred

Regulator	Pre Dodd–Frank Act	Post Dodd–Frank Act
	12 C.F.R. §1267.3(a)(4)(iii) provides another exception about 'Whole mortgages or other whole loans, or interests in mortgages or loans': Marketable direct obligations of state, local, or Tribal government units or agencies, having at least the second highest credit rating from an NRSRO, where the purchase of such obligations by the Bank provides to the issuer the customized terms, necessary liquidity, or favourable pricing required to generate needed funding for housing or community lending'	after acquisition of the instrument by the Bank' 12 C.F.R. §1267.3(a)(4)(iii) provides another exception about 'Whole mortgages or other whole loans, or interests in mortgages or loans': Marketable direct obligations of state, local, or Tribal government units or agencies, that are investment quality, where the purchase of such obligations by the Bank provides to the issuer the customized terms, necessary liquidity, or favourable pricing required to generate needed funding for housing or community lending....'
Federal Deposit Insurance Corporation (FDIC)	12 C.F.R. § 347.209(d)(3) provides that in terms of pledge of assets, 'commercial paper that is rated P-1 or P-2, or their equivalent by a nationally recognized rating service; provided, that any conflict in a rating shall be resolved in favour of the lower rating'	The same as before

Furthermore, US bank regulators use other models to replace the credit ratings in determining capital requirements. For example, federal regulators use two other models in the place of credit ratings in setting capital requirements for securitized products.[99] However, the concern about this approach is that regulators cannot ensure the accuracy of the new models. This approach still needs further examination in practice.

In short, the implementation of section 939A seems to have shown some progress in eliminating the hardwiring. Admittedly, the previous overreliance means that a certain level

[99] One model is Simplified Supervisory Formula Approach and the other is the Gross-up Approach. John Soroushian, 'Credit Ratings in Financial Regulation: What's Changed Since the Dodd–Frank Act?' (2016) 16–04 OFR Brief Series <https://www.financialresearch.gov/briefs/files/OFRbr_2016-04_Credit-Ratings.pdf> accessed 17 July 2020.

of reliance on credit rating is appropriate. A contained level of reliance on credit rating will not change until there is an effective alternative to credit ratings. Alternatives will bring new challenges and problems.

In the United States, after examining the work done with regard to the implementation of section 939A, there were two findings: First, the elimination of credit rating references from the regulation deviates from the original aim. For one thing, the exclusivity of credit ratings has been eliminated, while the presence of credit ratings has not been; in other words, credit ratings are still in the US regulations and rules. For another, the users of credit ratings expressed concern about the possible prohibition on the use of credit ratings. Second, the chances of finding a replacement for credit ratings seem slim. An adequate and universally accepted alternative has yet to be found. For example, the credit spread was proposed as an alternative by one commentator from the National Credit Union Administration, but no agreement was reached in this regard.[100] Furthermore, regulators are concerned that users of credit ratings will still, even exclusively, rely on credit ratings because they do not have an adequate alternative. These users choose credit ratings in the private sector, which may not reduce the risk of over-reliance on credit ratings. The current stage perhaps justifies the choice of market participants.

3.5.2 The Regulatory Approach at International and European Level

At international level, the Financial Stability Board (hereafter 'FSB') put forward Principles for Reducing Reliance on Credit Ratings (hereafter 'FSB Principles'), which is designed to reduce the mechanistic reliance on credit ratings. The FSB regulatory approach includes two stages: In the first stage, pursuant to Principle I[101] of the FSB Principles, the FSB starts with the elimination of hardwiring of credit ratings in regulation and rules.[102] The herding behaviours and the cliff edge effect increase the negative effects of rating downgrades on the liquidity problem, and the rating-based regulations and rules again aggravate such negative effects. in this regard, the rationale behind the Principle I aims to remove the credit rating references from the regulations and rules. At the second stage, according to Principle

[100] National Credit Union Administration, 'Alternatives to the Use of Credit Ratings' (2012) Final Rule, Federal Register 77 (240) <https://www.ncua.gov/regulation-supervision/corporate-credit-union-guidance-letters/final-rule-alternatives-use-credit-ratings> accessed 27 June 2020.

[101] Principle I. Reducing Reliance on CRA Ratings in Standards, Laws and Regulations. See Financial Stability Board, 'Principles for Reducing Reliance on Credit Ratings' 1 <https://www.fsb.org/wp-content/uploads/r_101027.pdf> accessed 20 May 2020.

[102] Under Principle I, the references to credit ratings in standards, laws and regulations should be removed or replaced with suitable alternative standards of creditworthiness. See in ibid.

II, FSB encourages investors and other market participants to undertake their credit risk assessment and due diligence independently instead of relying on external credit risk assessment.[103] The two intertwined stages comprise the FSB's approach. In addition, the FSB approach provides specific supplements to the two main principles regarding the establishment of internal credit risk assessment.[104]

Like section 939A of the Dodd–Frank Act, the FSB Principles confirmed that, again, the source of over-reliance is the rating-based regulation and rules. Therefore, the SEC and FSB approaches reduce the over-reliance on credit ratings by ceasing the hardwiring of credit ratings in legislation, regulation and rules. In contrast, compared to section 939A, the FSB Principles are further explicit, because they create incentives for investors and market participants to build an internal credit risk assessment system. In other words, this requires users of credit ratings, such as banks, institutional investors and firms, to improve their capability to conduct credit risk analyses. The FSB Principles further target dealing with the external reliance on credit ratings, which, in turn, has a positive influence on internal credit risk assessment systems.

The reason why FSB Principles are different from section 939A is that the rationale for the FSB Principles is to ameliorate the negative consequences of rating downgrades, namely herding behaviours and cliff edge effects. As addressed above, pursuant to some relevant regulatory requirements, asset managers have to sell their portfolio investments once ratings of such debt instruments have been downgraded to a speculative grade. Consequently, other investors are more likely to dramatically sell debt instruments, which can be regarded as mechanistic reliance on credit ratings. From a universal and sustainable perspective, the FSB argues that the herding and cliff effects are caused by the lack of independent credit risk assessment by investors themselves. Therefore, the regulatory strategy of the FSB Principles is to encourage investors to undertake their risk assessment and due diligence instead of relying on external credit ratings. In contrast, in the United States, the NRSRO, as a publicly reliable and approved entity, can be deemed to be a huge obstacle in reducing reliance on credit ratings. As a result, the SEC is inclined to weaken or cease governmental approval.

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[103] Principle II 'Reducing Market Reliance on CRA Ratings'. See in ibid 2.

[104] In order to implement the FSB basic principles regarding reducing over-reliance on external credit ratings, Principle III. Includes specific requirements for the central banks, banks, institutional investors, regulators and other market participants. See ibid 3–7.

Until 2013, Regulation (EU) No. 462/2013 (hereafter 'Regulation 2013')[105] attempted to deal with the over-reliance on credit ratings. Regulation 2013 fully endorsed the two main principles of the FSB Principles. In greater detail, Article 5(b)[106] and Article 5(c)[107] of Regulation 2013 implemented Principle I of the FSB Principles, while the contents of Article 5(a)[108] represent Principle II.

Both the United States' and European Union's respective strategies are to reduce the regulatory reliance on credit ratings which, to some extent, confirms the existing challenge to the over-reliance on credit ratings. Before the elimination of the rating-based regulation, both the European Union and United States have the relevant regulations regarding reviewing the hardwiring of credit ratings in legislation, regulations and rules. Section 939A requires the US federal agency to undertake the responsibility to review the rating-based regulation, while Article 5(b) requires the European Supervisory Authorities and European Systemic Risk Board to conduct the same task.[109]

However, there is a significant difference between the United States' and the European Union's regulatory approaches with respect to regulatory reliance on credit ratings: In the European Union, both Articles 5(b) and 5(c) suggest that when eliminating the hardwiring of credit ratings in legislation, regulation and rules, the precondition is that these credit ratings have the potential to trigger the sole and mechanistic reliance. In addition, with regard to alternatives to the existing rating-based regulation, Article 5(b) specifics that 'where appropriate', and Article 5(c) provides that when there are appropriate alternatives, such credit rating reference shall be eliminated, which are similar to the 'wherever possible' in Principle 1 of the FSB Principles. These provisions mean that the substitution of the rating-based regulations is not mandatory but more flexible. By contrast, in the United States, section 939A requires that those regulations and rules referring to the credit ratings must be identified and then such credit rating references must be removed and replaced with

[105] Regulation (EU) No. 462/2013 of the European Parliament and of the Council of 21 May 2013 Amending Regulation (EC) No. 1060/2009 on Credit Rating Agencies (OJ 2013 L 146).

[106] Article 5(b) requires the EU regulators and authorities to review and remove, where appropriate, the existing credit ratings in their regulation, guidelines, recommendations and standards, where such credit rating references have the potential to trigger the sole and mechanistic reliance on the credit ratings. ibid.

[107] Article 5(c) further requires the EU regulators and authorities to review and identify which credit rating references trigger or have the potential to trigger the sole and mechanistic reliance in the Union law and eliminate such credit rating references once there are appropriate alternatives. ibid.

[108] Article 5(a) requires financial institutions to conduct their own credit risk assessment and not exclusively or mechanistically rely on the credit ratings. ibid.

[109] Article 5(b) of ibid.

alternatives. The elimination of rating-based rules in the United States is much more complete.

In terms of the implementation, compared to the United States, the European Union has made less progress towards the removal of references to credit ratings from legislation, regulations and standards. The most important ground is that the EU approach is comparatively softer than the United States one, as compared above. According to Regulation 2013, two stages of reducing over-reliance includes review and removal. Before removing the relevant references to credit ratings, the regulators have to review whether or not a rating-based regulation can trigger mechanistic reliance. This review work does not proceed smoothly because the definition of *mechanistic reliance* is vague.[110] In addition, regulators eliminate credit rating references until there is an appropriate alternative. As addressed in the United States implementation section, the effectiveness of existing alternatives to credit ratings has not been examined. Thus, it still remains uncertain when it would be appropriate for the EU to eliminate rating-based legislation, regulation and standards.

In terms of capital requirements, the European Banking Authority (hereafter 'EBA') issued the Revised Guidelines on the Recognition of External Credit Assessment Institutions, which repealed credit rating references that were used in the standardized approach[111] to calculate capital requirements for credit risk for banking institutions.[112] However, owing to policy reasons, the level 2 guidelines cannot change the level 1 legislation.[113] Which is to say, the EBA's mandate cannot nullify any implementing legislation, such as Regulation 2009. This means that the EU implementation remains, to a larger extent, on paper. Like the United

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[110] The European Commission gave EBA a mandate to conduct the review but there was no specific definition before. In order to carry out the review, EBA put forward a broad definition of *mechanistic reliance*, namely 'it is considered that there is sole or mechanistic reliance on credit ratings (or credit rating outlooks) when an action or omission is the consequence of any type of rule based on credit ratings (or credit rating outlooks) without any discretion.' See European Banking Authority, European Insurance and Occupational Pensions Authority and European Securities and Markets Authority, 'Final Report on Mechanistic References to Credit Ratings in the ESAs' Guidelines and Recommendations' (2014), 8 <https://www.esma.europa.eu/sites/default/files/library/2015/11/jc_20 14_004_final_report_mechanistic_references_to_credit_ratings_rect.pdf> accessed 7 August 2020.

[111] The standardized approach is a tool used by banking institutions to calculate capital requirements for credit risk in a simple manner under the Basel II. This approach was subsequently introduced in the European Union via the CRD III legislation (Directives 2006/48/EC and 2006/49/EC7). Basel III follows the same approach even though it requires banking institutions to reduce the use of external ratings. See ibid 14.

[112] European Banking Authority, 'Revised Guidelines on the Recognition of External Credit Assessment Institutions' (2010) <https://eba.europa.eu/sites/default/documents/files/documents/10180/16094/40314f29-99be-4de4-bedb-6abb41d35bef/Revised-Guidelines.pdf?retry=1> accessed 6 July 2020.

[113] European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority (n 110) 6.

States, a certain level of market reliance remains because there is no effective alternative to credit ratings.

Another point of the EU approach is to enhance the internal credit risk assessment. Many central banks have expanded their own credit risk assessment system.[114] The main obstacle to this task is that smaller financial institutions are unable to conduct their own credit rating analyses.[115] Compared to small financial institutions, only these large and sophisticated financial institutions are capable of establishing internal credit assessment, because they have more access to capital and information.

3.5.3 China's Regulatory Approach

The financial crisis of 2007–8 brought the discussion of credit ratings to China. Xiaochuan Zhou, former Governor of the PBOC, confirmed the significant role of credit rating in the financial system.[116] Zhou indicated that the over-reliance on external credit ratings amplified the procyclicality in the financial system.[117] in 2008, the PBOC issued the 'Notice of the People's Bank of China on Strengthening the Management of the Credit Rating Practices in Inter-Bank Bond Market'[118] which further enhanced the regulation and supervision on credit ratings in the interbank market.[119] On 25 December 2011, Zhou suggested that all the regulations and rules relying on external credit ratings should be removed, and the large financial institutions were supposed to enhance their credit assessment and reduce their reliance on external credit ratings. As a response, on 26 November 2011, the CBRC[120] issued the 'Notice of China Banking Regulatory Commission on Regulating Commercial Banks'

[114] Financial Stability Board, 'Thematic Review on FSB Principles for Reducing Reliance on CRA Rating' (2014) Peer Review Report <https://www.fsb.org/wp-content/uploads/r_140512.pdf> accessed 30 July 2020.
[115] European Commission, 'Report from The Commission to the European Parliament and The Council on Alternative Tools to External Credit Ratings, the State of the Credit Rating Market, Competition and Governance in the Credit Rating Industry, the State of the Structured Finance Instruments Rating Market and on the Feasibility of a European Credit Rating Agency' COM(2016) 664 Final, 6.
[116] Xiaochuan Zhou [周小川], 'Some Questions and Outlooks about Credit Ratings [关于信用评级的若干问题及展望]' <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/2856526/index.html> accessed 6 June 2020.
[117] ibid.
[118] People's Bank of China, 'Notice of the People's Bank of China on Strengthening the Management of the Credit Rating Practices in Inter-Bank Bond Market [关于加强银行间债券市场信用评级作业管理的通知]' No.75 [2008] of the People's Bank of China [银发[2008]75 号].
[119] Annex I,'On-Site Interview Practices of the Credit Rating Agencies' [信用评级机构评级作业主要流程单], ibid.
[120] [中国银监会]

Use of External Credit Ratings,[121] which provides more restrictions regarding the use of external credit ratings for commercial banks.

However, encouraging domestic CRAs becomes another important regulatory strategy against the over-reliance on external credit ratings. A 2010 report with regard to credit rating and financial stability states that the global rating system was, to a large extent, dominated by US CRAs,[122] which is likely to pose a severe threat to Chinese finance security.[123] Hence, according to the report, it is incumbent upon China to support domestic CRAs and greater competition.[124] With reference to both the EU and US regulatory approaches, Zhou, during the 2018 China Economic Foresight Forum, offered two suggestions: (i) The domestic financial institutions should be encouraged to enhance their own credit risk assessment; and (ii) Like the rotation regime of the European Union, a dual ratings model (one rating provided by an international CRA, the other provided by a domestic CRA) could serve as a reform attempt in China.[125] However, all of these discussions remain at a theoretical stage and need to be revisited in future.

In short, the Chinese regulatory strategy includes two things: the first is to reduce the over-reliance on external, even foreign, credit ratings, and the second is to establish a stronger internal credit assessment system within financial institutions. However, the implementation of such regulatory approaches has shown limited progress.

3.6 Conclusion

Having illustrated the regulatory use of credit ratings in regulatory systems above and the existing regulatory approaches against the over-reliance on credit ratings, some considerations can be highlighted as follows: First, in terms of the elimination of rating-

[121] China Banking Regulatory Commission, 'Notice of China Banking Regulatory Commission on Regulating Commercial Banks' Use of External Credit Ratings [关于规范商业银行使用外部信用评级的通知]' (2011) No.10 [2011] of China Banking Regulatory Commission[银监发〔2011〕10 号].

[122] Two of big three (namely Moody's and S&P) are US CRAs and Fitch is now majority-owned by a French CRA. See House of Lords European Union Committee, 'European Union Committee 21st Report. Sovereign Credit Ratings: Shooting the Messenger?' (Authority of the House of Lords 2011) HL Paper 189, 24.

[123] The topic of a series of reports is 'Credit Rating and National Finance Security' [信用评级与国家金融安全]. See Xiukun Peng [彭秀坤], 'Research on the International Community's Regulation and Reformation of Credit Rating Agencies [国际社会信用评级机构规制及其改革研究]' (PhD Thesis, University of Suzhou 2012) 143–4.

[124] ibid 143.

[125] Xiaochuan Zhou [周小川], 'Reducing the Reliance on Foreign Credit Rating Agencies [减少对国外信用评级机构依赖]' (*Banker's Forum in China Banking Association*, 2019) <https://www.china-cba.net/Index/show/catid/82/id/154.html> accessed 26 June 2020.

based regulation, the United States removed the exclusivity of credit ratings in US legislation, but the users of credit rating still rely on these ratings. At this point, the work of elimination in both the European Union and China is behind that in the United States. One of reasons for this is that the extent of regulatory reliance on credit rating in the European Union and China is lower than that in the United States. As opposed to the United States, credit ratings have not been as extensively incorporated into European Union's and China's financial legislation. In addition, the European Union and China never confer any special regulatory status on particular CRAs, compared to NRSROs in the United States.

Second, the fear of over-reliance on foreign credit ratings in the European Union and China seems more significant, which provides incentives for both to support and encourage national or regional CRAs. This is because most of the financial legislation in the European Union and China does not include many credit ratings. As a consequence, the European Union put forward the rotation regime to deal with this fear, while China provides a similar regulatory attempt at a dual rating model. Apart from that, the progress made with the implementation in the European Union is more advanced than that in China. One possible explanation is that the risk of over-reliance on credit ratings in the financial market has severer influence on the European Union, which was verified during the financial crisis of 2007–8 and the subsequent euro area crisis. This is perhaps caused by more mutual links between the EU and US financial market, and also results from the various extents in the development of the bond markets in the European Union and China. As mentioned above, the complex structured financial products, including re-securitisation or synthetic securitisation, cannot be allowed in the Chinese bond market. As a result, even though the Chinese regulators have realized the risk of over-reliance on credit ratings for the financial stability after the financial crisis to deal with the over-reliance on credit ratings it does not seem to be a regulatory priority.

Third, without an effective alternative to credit ratings, the reliance on credit ratings by the market will remain for a certain period in the future. However, this does not mean there is no need to continue the current regulatory approaches. As seen above, in conjunction with Chapter 2, the regulatory and market reliance on credit ratings exist for long time. Currently, the market and relevant regulators still need to rely on the credit ratings in many respects. Therefore, the continuing implementation of these regulations against the over-reliance are needed in the long run.

Chapter 4: Conflicts of Interest in Credit Rating Agencies

4.1 Introduction

As illustrated in Chapter 3, besides the over-reliance on credit ratings, another focus on CRAs is the rating quality. In order to improve the quality of ratings, three aspects, namely (i) conflicts of interest, (ii) oligopoly and (iii) the civil liability for CRAs need to be analysed (Chapters 4,5 and 6 of this thesis). The three relevant issues interreact with each other and have a joint impact on the regulatory approaches. In this chapter conflicts of interest will be discussed first.

Credit rating, as a tool to reduce information asymmetry, was originally designed to assess the default risk of an obligor. As it adapts to the market demand, CRAs play various roles in the financial market, including pricing securities, restructuring financial instruments and sustaining the stability of financial institutions. However, CRAs were severely criticized with respect to the failure in structured finance during the global financial crisis of 2007–8.[1] There are many different explanations and rethinking behind the failure of credit ratings. The question is the same, namely why they fail to provide prompt accurate ratings. Analysts regarded various and complicated conflicts of interest within the credit rating industry as contributing factors that compromise the integrity and independence of CRAs. In this chapter, the common and typical conflicts of interest within CRAs, and whether they are the dominant factors of rating failure are analysed. If so, how do they affect the accuracy and independency of credit ratings; if not, what are the more severe factor contributing to the rating failure?

Above all, the typical conflicts of interest from an individual level and an agency level will be examined, and then the efficiency of the relevant existing regulation against the specific conflict will be discussed individually. At the individual level, the conflicts of interest involve the ownership of securities of rated entities, unusual business relationships and the compensation system. There have been some effective regulation and internal control measures against such conflicts. However, in comparison, conflicts at the agency level are more complex than those at the individual level. There are also difficulties in the symmetrical regulation. Therefore, an attempt will be made to analyse what causes difficulties in

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[1] Technical Committee of the International Organization of Securities Commissions, 'The Role of Credit Rating Agencies in Structured Finance Markets Final Report' (2008) 2 <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf> accessed 10 October 2018.

regulating CRAs in respect of conflicts of interest at the agency level, and why the existing regulations related to conflicts at the agency level are ineffective and weak.

Last, the issuer-pays model was regarded as the root of conflicts of interest, and many proposals aim to change the business model. However, this chapter tries to solve the conflicts of interest from another perspective, namely structured finance. It will address the fact that both rating failure and the failure of reputation mechanism focus on structured finance. In addition, the financial crisis has less impact on China, because it has many limitations in structured finance. Given the complexity of structured finance, to ensure the rating quality, one possible solution may limit the issuance of structured financial products rather than the reform of the business model.

4.2 Conflicts of Interest in Credit Rating Agencies

Conflicts of interest regarding credit rating takes place where an agency or staff within the agency have an incentive to compromise their integrity for their own personal interest during a rating activity.[2] There are various conflicts of interest within CRAs. This section will introduce the common conflicts of interest at the individual and the agency level, and show how such conflicts affect CRAs.[3] At the individual level, conflicts feature in the possible situation of conflicts arising from the personal interests of employees, including the ownership of securities of rated entities and the dual positions of both a CRA and a rated firm, the unusual business relationship and the potential incentive under the compensation system relating to the rating fee. The last-mentioned conflicts mainly focus on the conflicts at the agency level, including the larger subscriber effect, ancillary services and rating shopping.

4.2.1 Conflicts of Interest at the Individual Level

From an individual perspective, this conflict may arise from the personal interests of employees within CRAs. If the rating activity itself affects the interest of employees in CRAs who are able to change or determine the rating, the employee is more likely to compromise his/her integrity in favour of his/her interests. The common situations involve the following:

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[2] Cristian Marzavan and Tănase Stamule, 'Conflicts of Interest's Management within Credit Rating Agencies' (2009) 4(3) Management & Marketing 111.
[3] Lynn Bai, 'On Regulating Conflicts of Interest in the Credit Rating Industry' (2010) 13(2) New York University Journal of Legislation and Public Policy 253, 260.

a. The Ownership of Securities of Rated Entities or Holding a Position in Rated Entities

The first conflict of interest arises when an employee in a CRA who is both directly or indirectly associated with the rating process, owns the securities of rated entities or holds a position at a rated entity. In terms of ownership of securities from rated entities, both direct ownership and indirect ownership of employees in a CRA may give rise to an incentive for the employees to issue favourable ratings. For example, regarding the dual positions of a CRA and rated entity, Clifford L. Alexander, Jr once held a position on the board of WorldCom, and he was also the Chairperson of Moody's at the same time. During this period, WorldCom held a favourable investment-grade credit rating, even though the market had regarded it as a bond at speculative level. Alexander resigned from WorldCom in December 2001, and six months later WorldCom went bankrupt. During the four months starting from his resignation, the credit rating of WorldCom was still kept at investment level.[4]

b. Unusual Business Relationship

Another conflict takes place when an employee in a CRA who is both directly or indirectly associated with the rating process, and receives any kind of gift from rated entities, or there is any kind of unusual relationship between an employee in the CRA and a rated entity. For example, an employee at a CRA who borrows money at a market-down rate from a rated form, may be inclined to issue an over-optimistic credit rating.

c. Compensation System

Under the issue-pays model, as a prerequisite, if the compensation system of analysts associates with a rating fee in whole or in part, analysts would have the incentive to achieve a higher turnover for the sake of a higher salary. In order to pursue more business opportunities and increase turnover, rating analysts are likely to compromise their professional integrity and to compete with other rating analysts or CRAs through using lax rating criteria, because issuers usually choose the most favourable rating. That may give rise

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[4] Alec Klein, 'Moody's Board Members Have Ties to Client-- Firm Says Such Links Have No Impact on Ratings' *Washington Post* (22 November 2004) A09 <http://www.washingtonpost.com/wp-dyn/articles/A3057-2004Nov21.html??noredirect=on> accessed 20 November 2018.

to rating inflation and rating shopping.[5] Furthermore, this compensation system undermines the independence, credibility and neutrality of rating analysts.

4.2.2 The Existing Regulation Conflicts of Interest at the Individual Level

a. The Ownership of Securities of Rated Entities or Holding a Position in Rated Entities

In the United States, according to Rule 17g-5(c)(2), an NRSRO shall not issue or maintain a credit rating where an employee or analyst in an NRSRO either engages in determining ratings or is able to approve ratings, and is also able to directly own securities of a rated entity or own any kind of direct ownership interest in a rated entity.[6] Besides, Rule 17g-5(c)(4) prohibits NRSRO from issuing or maintaining a credit rating where its analyst who engages in determining credit ratings or a person who is responsible for approving credit rating, is also an officer or director in the rated entity.[7]

In the European Union, when a person in a CRA 'directly or indirectly owns financial instruments of [a] rated entity or has any other direct or indirect ownership interest in that entity or party', Regulation(EC) No 1060/2009 (hereafter 'Regulation 2009')[8] requires a CRA to disclose immediately the relevant situation as well as assess whether to re-rate or withdraw the existing rating in case of an existing rating, or not provide a rating service.[9] Regulation 2009 also prohibits CRAs from issuing a credit rating or disclosing immediately in the context of an existing rating when a person in that CRA is 'a member of the administrative or supervisory board of the rated entity'.[10]

In China, Article 34 of the Interim Measures for the Administration of the Credit Rating Industry (hereafter 'Interim Measures 2019') prohibits a CRA from providing a rating

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[5] Rating shopping takes place where an issuer selects a CRA provided that this CRA assigns a favourable rating for an issuer with the laxest rating criteria. See Mark Adelson, 'Rating Shopping –Now the Consequences' (Nomura Fixed Income Research 2006) 1 <http://www.markadelson.com/pubs/Rating_Shopping.pdf> accessed 10 October 2019.
[6] SEC adopted Rules 17g-1 to 17g-6 to meet the requirements of Credit Rating Agency Reform Act of 2006. See SEC, 'Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations' (2007) Release No. 34-55231; File No. S7-04-07, 10 and 171 <https://www.sec.gov/rules/proposed/2007/34-55231.pdf> accessed 10 November 2018.
[7] ibid 171-2.
[8] Regulation (EC) No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies (OJ 2009 L 302).
[9] Annex I section B3(a) of ibid.
[10] Annex I section B3(c) of ibid.

service when: (i) the de facto director of the CRA and rated entity are the same person; (ii) the de facto director of a rated entity or issuer directly or indirectly owns five per cent and above shares of the CRA; and (iii) the de facto director of the CRA directly or indirectly owns five per cent and above shares of the rated entity, or purchases the relevant securities of the rated entity within six months.[11] According to section 8(7) of the Guiding Opinions of the People's Bank of China for the Management of Credit Rating of 2006 (hereafter 'Guiding Opinions 2006'),[12] an executive in a CRA is prohibited from holding a position in another firm that may cause conflicts of interest.[13]

b. Unusual Business Relationship

In the United States, Exchange Act Rule 17g-5(c)(7) prohibits the person who is related to a rating process in an NRSRO from receiving gifts worth more than USD 25. Rule 17g (5)(b)(1)-(5) introduces various acts of bribery conflicts of interest, and Rule 17g (5)(b)(7) lists other unusual business relationships between a person in an NRSRO and a rated entity. [14]

Even though they both lack specific statuary regulation targeting business relationships that may cause conflict of interest, both the European Union and China incorporate corporate governance as a supplementary form of regulation. In the European Union, according to Regulation 2009, a CRA should establish appropriate internal policies and corporate governance to avoid possible conflicts of interest and ensure their independency.[15] In China, according to section 4 of Guiding Opinions 2006, CRAs should establish internal corporate governance to avoid potential conflicts of interest. Section 5(4) adds a principle of avoidance relating to conflicts of interest. Furthermore, section 8(2) forbids employees within a CRA from providing credit rating for a third party who may cause any kind of conflicts of

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[11] Article 34 of Interim Measures for the Administration of the Credit Rating Industry [信用评级业管理暂行办法] 2019 (No. 5 [2019] of People's Bank of China, the National Development and Reform Commission, the Ministry of Finance and the China Securities Regulatory Commission).
[12] Guiding Opinions of the People's Bank of China for the Management of Credit Rating [中国人民银行信用评级管理指导意见] (No. 95 [2006] of the People's Bank of China [银发[2006]95 号]).
[13] Article 8(7), ibid.
[14] SEC, 'Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations' (n 6) 87-91.
[15] Recital 4 of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies.

interest.[16] This requires that the CRA and a person in that CRA shall avoid any kind of potential conflicts of interest. However, these regulations are vague and general.

c. Compensation System

In the United States, section 15E of Credit Rating Agency Reform Act of 2006 requires a separation between the compensation of a compliance officer or independent director and their financial or business performance.[17] In addition, Rule17g-(3)(b)(1) requires an NRSRO to report the compensation of analysts to the SEC. However, it lacks a specific prohibition or separation between the compensation system of employees, especially analysts, and marketing activities. In the European Union, in order to cope with conflicts of interest and ensure the independence of credit rating, CRAs shall not associate compensation of employees with business performance.[18] China did not provide legislation related to the separation between the compensation system of employees and marketing activities until the Interim Measures 2019.[19] In addition, there are some relevant targeting rule in corporate governance and internal codes of CRAs. For example, CCXI[20] separates the compensation system of staff from the rating fees.[21] The conflicts with respect to the compensation system also leads to rating shopping, which will be discussed further below.

4.2.3 Conflicts of Interest at the Agency Level

a. Larger subscriber Effect

Under the investor-pays model, the large subscriber, as an often-neglected cause, has an important influence on the rating behaviour of CRAs. When the interest of the large subscriber depends on the rating of some particular securities that are rated by CRAs, the

[16] Article 8(2) of Guiding Opinions of the People's Bank of China for the Management of Credit Rating [中国人民银行信用评级管理指导意见].
[17] Section 15E (j)(4) and (t)(2)(C) of *The Securities Exchange Act of 1934* amended by Credit Rating Agency Reform Act of 2006 *(Pub L No 109–291, 120 Stat 1327).*
[18] Annex I section A(2), Regulation (EC) No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies.
[19] Article 37, Interim Measures for the Administration of the Credit Rating Industry [信用评级业管理暂行办法].
[20] China ChengXin International Credit Rating Co., Ltd (CCXI) [中诚信国际信用评级有限公司] <http://www.ccxap.com/About.aspx> accessed 6 July 2019.
[21] CCXI, 'Internal Code of Conflicts of Interest Regarding Non-Rating Service[中诚信国际利益冲突与回避管理制度]' (2018) section 3.2 <http://www.ccxi.com.cn/cn/Init/baseFile/1346/584> accessed 30 December 2018.

CRA under pressure is likely to issue some favourable rating or delay the downgrade for fear of losing this big client. For example, if a fund manager who is big client of one CRA and who, according to regulation or some rules is required to invest a security with a minimum A credit rating, has an interest in one security below an A rating, the CRA, for fear of losing revenue from the big client, may choose to provide an inaccurate rating. [22]

b. Ancillary Service

The development of ancillary service gives rise to conflicts of interest. Early in 2003, the SEC had already reported that some ancillary services provided by NRSROs, such as pre-rating assessments and corporate consulting, exacerbated conflicts of interest.[23] The main concerns regarding this conflict are: On the one hand, a credit rating may be affected by whether or not the issuer purchases the ancillary service offered by the CRA. Based on this point, the CRA puts pressure on issuers in order to sell their ancillary services, given the issuer's fear of a potential lower rating. On the other hand, under the issuer-pays model, the issuer conversely pressurizes the CRAs through threatening to stop purchasing ancillary services in pursuit of a higher rating.[24] In addition, in 2013, an ancillary service was revealed to be involved in other conflicts of interest, that is, the CRA participated in the construction or design of structured financial products. Some CRAs provide ancillary services through their affiliates rather than themselves. Further to the concerns mentioned above, it raises a concern that providing ancillary services by the affiliates will increase the difficulty of regulating and managing the potential conflicts.

Given the fact that some consultancy or advisory services related to credit rating activities present conflicts of interest, many regulatory prohibitions have been designed to prohibit these consultancy or advisory services. Owing to the huge profits created by extra additional services for CRAs or their affiliates, especially relating to structured finance, CRAs have sufficient incentives to offer additional services in practice.[25] Therefore, except for the banned services, the other services provided by CRAs could be regarded as ancillary services, even though some of these services still present conflicts of interest. Because of the stricter disclosure and reporting requirement of conflicts of interest within CRAs, CRAs began to

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[22] Lynn Bai (n 3) 263.
[23] SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets' (2003) 42 <https://www.sec.gov/news/studies/credratingreport0103.pdf> accessed 20 April 2020.
[24] ibid.
[25] Harry McVea, 'Credit Rating Agencies' the Subprime Mortgage Debacle and Global Governance: The EU Strikes Back' (2010) 59(3) International and Comparative Law Quarterly 701, 713.

transfer ancillary services to their affiliates. It is worth noting before continuing that there are three cruxes to the issue: (i) the vague definition, (ii) the provision of ancillary services by an affiliate of a CRA and (iii) sufficient incentives to provide ancillary services in the context of structured finance.

c. Rating Shopping

Rating shopping, as discussed in relation to the individual compensation system above, occurs when issuers are inclined to choose a CRA that provides the most favourable rating for them.[26] Under the issuer-pays model, the chance is high that CRAs would use lax criteria and downplay the credit risk in order to get more business opportunities or to retain a business relationship with issuers.[27] According to recent German research, Standard & Poor's (hereafter 'S&P') was criticized by the Fitch Ratings (hereafter 'Fitch') in public because S&P' was suspected of drafting an inaccurate credit rating report on purpose so as to favour the issuers.[28] The issuer-pays model creates a huge incentive for CRAs to provide favourable ratings for issuers. Furthermore, once a certain number of CRAs used to compete with each other by applying utilising lax criteria, other CRAs suffer from pressures of their clients and take the risk of losing revenue when they attempt to keep their integrity.[29] This practice may not only lead to rating inflation, but also undermines the credibility of credit rating and the independence and neutrality of CRAs.

Rating shopping is also one typical issue in China. For example, Dagong Global Credit Rating Agency (hereafter 'Dagong'), as one of the major CRAs in China, was criticised for issuing the highest rating (i.e., AAA) 156 times in 2010, even though Dagong explained that 156 was the overall rating given to all bond issuances and the actual amount of issuers given AAA was 39, accounting for 11.5 per cent of all rated issuers.[30] However, that Dagong issued an AAA rating to a super short-term bond from the Ministry of Railways in August 2011 was criticised by the public. At that time, the Ministry of Railways was trapped in the event where two high-speed trains crashed killing 40 people and injuring 192. At that

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[26] Lynn Bai (n 3) 263.
[27] ibid 263.
[28] Thomas M. J. Möllers and Charis Niedorf, 'Regulation and Liability of Credit Rating Agencies: A More Efficient European Law?' (2014) 11(3) European Company and Financial Law Review 333
[29] Yinping Xu and Charlie Xiao-chuan Weng, 'Introduction and Suggestions on the Chinese Securities Credit Rating System from a Comparative Perspective' (2011) 6 University of Pennsylvania East Asia Law Review 217, 225.
[30] Wei Tian, 'Dagong Refutes Claims of AAA "Generosity"' (20 August 2011) <http://www.chinadaily.com.cn/business/2011-08/20/content_13155412.htm> accessed 20 August 2018.

moment, the public across the country doubted the future of high-speed railways. The stock market was also affected by this crash: shares in China Rail Construction, the biggest company that builds more than the half of all rail links, fell by 6.7 per cent[31]; shares in CSR Corp., the builder of one of the two trains in this crash, fell by 14 per cent, while shares in China Automation Group Ltd., which is responsible for the safety and control system of railways, fell by 19 per cent.[32] Despite this, Dagong still issued an AAA rating to the Ministry of Railways, which is even higher than China' s sovereign debt rating.

Dagong explained that this bond was mostly backed by the Ministry of Railways, namely the government, and that it was hardly possible for the government to be insolvent. Nevertheless, this argument is untenable because a government does not go bankrupt nominally, which does not mean that material default of government bonds is impossible in practice. First, currency devaluation is the normal way in which to cope with the default of government bonds, which happens in many countries. Second, Chinese local governments are not allowed to be insolvent while the local government platform, which issues city investment bonds that is a kind of quasi municipal bond, is allowed to be legally insolvent.[33] Third, some SOEs in China went bankrupt. Because of the socialism in China, the bonds of SOEs have similar characteristics to government bonds, because government exercises power on behalf of Chinese citizens, while the theoretically real owner of SOEs is all citizens and the government, the State-owned Assets Supervision and Administration Commission,[34] is the nominal owner. Therefore, rating shopping is another possible explanation for the fact that the rating is irrationally high. Apart from that, an analyst within one CRA disclosed that CRAs charge issuers depending on at which rating level it sells.[35] The higher the credit rating was, the more the CRA charged.

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31 Chris Cooper, 'China Crash May Give "Zero" Chance for Bullet-Train Exports' (25 July 2011) <https://www.bloomberg.com/news/articles/2011-07-26/china-has-zero-chance-on-high-speed-train-exports-after-crash-kills-39> accessed 20 February 2019.

32 Norihiko Shirouzu, 'Beijing Seeks to Soothe Train Jitters' (26 July 2011) <https://www.wsj.com/articles/SB10001424053111904772304576468094211307726> accessed 20 February 2019.

33 Article 5(5) of The Guiding Opinions on Strengthening Asset-Liability Constraints on State-owned Enterprises [关于加强国有企业资产负债约束的指导意见] 2018 (The General Office of the CPC (Communist Party of China) Central Committee and the General Office of the State Council [中共中央办公厅和国务院办公厅]).

34 [国务院国有资产监督管理委员会]

35 Manli Su [苏曼丽], 'Foreign Investment Frantically Infiltrate China's Domestic Rating Agencies [外资"疯狂"渗控中国评级机构]' (China News [中国新闻网], 15 August 2011) <http://finance.people.com.cn/bank/GB/15414081.html> accessed 20 February 2019.

4.2.4 Existing Regulation and Difficulty of Regulating Conflicts at the Agency Level

a. Larger Subscriber Effect

To cope with potential conflicts resulting from large subscribers, in the United States, Rule 17g-5(b)(5) requires NRSROs to warn investors of the existence of such a conflict, and to maintain policies and procedures so as to manage this conflict. Even though there is no specific requirement, section 15E(1)(B)(viii)[36] and Exhibit 10 of Form NRSRO[37] requires NRSROs to disclose the 20 largest issuers and subscribers who purchased rating services and products by the amount of net revenue in the fiscal year. Furthermore, under Rule 17g-2(a)(4), NRSROs are required to open an account for each subscriber, and the required information includes the identity and address of each subscriber. The European Union and China manage the potential influence of larger subscribers through disclosure and transparency.

b. Ancillary Services

There are some existing prohibitions against conflicts of interest arise from ancillary services. In the United States, Rule 17g-5 (b) (3)[38] addresses the conflicts of interest associated with the provision of ancillary services by NRSROs, while Rule 17g-5(c)(1)[39] addresses the prohibited conflicts of interest regarding ancillary services. In order to avoid conflicts arising from an affiliate of an NRSRO, Rule 17g-4 to 6 defines the meaning of *relevant person*, which includes the person within an affiliate of one NRSRO. Furthermore, Rule 17g-5(c)(5) addresses 'the potential lack of impartiality that may arise when an NRSRO determines a credit rating based on a corporate structure that was developed after consultations with the NRSRO or its affiliate on how to achieve a desired credit rating'[40], and it 'prohibits an

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[36] Section 15E(1)(B)(viii) of *The Securities Exchange Act of 1934* amended by Credit Rating Agency Reform Act of 2006. .

[37] SEC, 'Form NRSRO: Application for Registration as a Nationally Recognized Statistical Rating Organization (NRSRO)' Instructions to Exhibit 10 <https://www.sec.gov/aboutlforms/formnrsro.pdf> accessed 20 February 2019.

[38] The conflict is: 'being paid for services in addition to determining credit ratings by issuers, underwriters, or obligors that have paid the nationally recognized statistical rating organization to determine a credit rating.' See SEC, 'Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations' (n 6) 89-90.

[39] Rule 17g-5(c)(1) prohibits an NRSRO from issuing or maintaining a credit rating when a rating agency solicited by a person who provided the NRSRO with net revenue greater than or equal to 10 per cent of total net revenue of the NRSRO for the most recently ended fiscal year. ibid 92.

[40] SEC, 'Amendments to Rules for Nationally Recognized Statistical Rating Organizations' (2009) <https://www.sec.gov/rules/final/2009/34-59342.pdf> accessed 13 March 2019.

NRSRO from rating its own work or the work of an affiliate'[41]. In the European Union, Under Regulation 2009, CRAs were prohibited from offering consultancy or advisory services and making recommendations with respect to the construction of structured financial products.[42] Later, in 2013, the prohibition was expanded to shareholders of CRAs. A CRA or any person who either directly or indirectly owns at least five per cent capital, or has a significant effect on the business activities of a CRA, is not allowed to provide consultancy or advisory services to the rated entity or related third party.[43]

Both the United States and European Union have prohibitions against the provision of consultancy and advisory service, but there was no express prohibition in China until 2019.

In August 2018, Dagong was punished by relevant regulators because it was involved in conflicts of interest when providing ancillary services. China's National Association of Financial Market Investors[44] (hereafter 'NAFMII'), a non-governmental self-regulatory organisation, gave Dagong a severe warning that Dagong would be prohibited from engaging in any business activities regarding debt financial instruments.[45] Furthermore, the CSRC, as one of main regulators as mentioned in Chapter 2, prohibited Dagong from providing all kinds of rating services for one year, both in the interbank market and on the securities exchange.[46] That was because Dagong had been involved in promising a higher rating or threatening with lower ratings in order to sell ancillary services. Dagong required issuers who intended to purchase rating services from itself to purchase a 'management system of supply chain finance'[47] before it provided a rating service. If an issuer refused to purchase this system, Dagong would give the issuer a lower rating until it had purchased the system.

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[41] ibid.

[42] Annex I, section B, Point 4, Regulation (EC) No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies.

[43] Annex I (1) (d) and Annex II (1) (a) 22, Regulation (EU) No. 462/2013 of the European Parliament and of the Council of 21 May 2013 Amending Regulation (EC) No. 1060/2009 on Credit Rating Agencies (OJ 2013 L 146).

[44] [中国银行间市场交易商协会]

[45] Yan Zhang [张燕], 'Dagong Was Prohibited from Suspending Rating Services[大公国际被罚"暂停评级业务"]' (29 August 2018) <http://3g.ceweekly.cn/article/12048> accessed 21 February 2019.

[46] Dagong's misbehaviors violated the relevant regulations and rules of Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market[证券市场资信评级业务管理暂行办法] (No 50 [2007] of China Securities Regulatory Commission [证监发[2007] 50 号]). See CSRC, 'CSRC Suspended Dagong Securities Rating Business for One Year [证监会暂停大公国际证券评级业务一年]' (2018) <http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201808/t201808 17_342750.html> accessed 22 February 2019.

[47] [供应链金融管理系统]. The service of 'management system of supply chain finance', a kind of ancillary service that is designed by Dagong, contains conflict of interest with its rating service.

According to an investigation by regulators, 31 issuers who had purchased this system from Dagong and their credit ratings were upgraded from AA+ to AAA later.[48]

However, there are many impediments to manage the conflict arising from the ancillary service. First of all, the term *ancillary service* has not been clearly defined yet, even though some pre-rating ancillary services have been forbidden in the United States and European Union.[49] Given the difficulty to distinguish between ancillary services and such consultancy or advisory services relating to conflicts, CRAs still provide many ancillary services. In practice, each CRA has various definitions of *ancillary service*, such as 'permissible services' provided by Moody's, as well as ancillary and other services provided by S&P.

More importantly, ancillary services comprise 'market forecasts, estimates of economic trends, pricing analysis and other general data analysis as well as related distribution services'.[50] Therefore, the difficulty in determining the scope of ancillary services is that many publications issued by big CRAs are alleged by the CRAs to be normal publications instead of derivatives of the rating service. Even though some publications provided by CRAs in the name of non-rating publications, these publications still have the same effect on the market. In the case of *Moody's Investors Service Hong Kong Limited v Securities and Futures Commission*, Moody's was fined by the Securities and Futures Commission (hereafter 'SFC) because Moody's had published a report entitled 'Red Flags for Emerging-Market Companies: A Focus on China', which was regarded as misleading and inaccurate by the SFC.[51] However, Moody's sued the SFC on the grounds of the non-credit rating report. In terms of ancillary services, this conflict involved a CRA that rated securities at the same time as providing ancillary services for the issuer, such as debt restructuring or risk management consulting.[52] CRAs have incentives to provide ratings that favour rated entities so that they can maintain ancillary services with such entities.[53] In addition, this conflict of interest also puts pressure on issuers. In order to pursue high credit ratings, issuers may reluctantly purchase the ancillary services from CRAs that provide credit rating services at

[48] Yan Zhang [张燕] (n 47).
[49] Raquel García Alcubilla and Francisco Javier Ruiz del Pozo, *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (Oxford University Press 2012) 145.
[50] ESMA, 'Report on CRA Market Share Calculation' (2018) 1 <https://www.esma.europa.eu/sites/default/files/library/cra_market_share_calculation_2018.pdf> accessed 21 March 2019.
[51] *Moody's Investors Service Hong Kong Limited v Securities and Futures Commission* Hong Kong Special Administration Region HKCFA 42; (2018) 21 HKCFAR 456; FACV 6/2018.
[52] Alec Klein (n 4) 260.
[53] ibid.

the same time. By contrast, if an issuer refuses to purchase the ancillary service from a CRA, it may incur downgrades in its credit rating.

In addition, according to Moody's policy regarding 'other permissible service', besides credit rating services, Moody's only provides bond fund rating, credit estimates, indicative assessment and rating assessment services, which are all distinct from the ancillary service (consulting or advisory service).[54] All such ancillary services listed in this thesis appeared to be offered by Moody's Analytics. As can be seen from Figure 4.1 below, Moody's Analytics is a subsidiary of Moody's Corporation which is also the Moody's (Moody Investor Service) parent entity. Like Fitch Solution, Moody's Analytics is a non-NRSRO company and provides many financial services, except rating services. The services provided by Moody's Analytics mainly include market-implied ratings,[55] financial institution research and performance data services.[56] Market-implied ratings can be regarded as complementary to credit ratings offered by Moody's (Moody's Investor Service).[57]

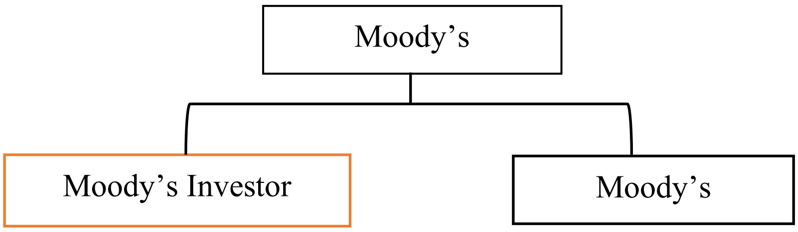

Figure 4.1 Moody's Corporation Organizational Structure[58]

Besides to credit rating services, S&P (S&P Global Rating) also provides ancillary services and other services. Ancillary services in S&P means a product or service is not a credit rating or credit rating activity, but is either a market forecast, an estimate of economic trends, a pricing analysis, other general data analysis, or distribution services related to a credit rating, a market forecast, an estimate of economic trends, a pricing analysis or general data analysis.

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[54] Moody's Investor Service, 'The Rating Symbols and Definitions' for the Part in 'Other Permissible Services' (2019) 14 <https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004> accessed 30 December 2019.

[55] A market-implied rating 'translates prices from the Credit Default Swap (hereafter 'CDS'), bond, loan and equity markets into standard (Moody's) ratings language'. See Moody's Analytics, 'Market Implied Ratings FAQ' (June 2010) <https://www.moodys.com/sites/products/ProductAttachments/MIRFrequentlyAskedQuestions.pdf> accessed 12 March 2019.

[56] SEC, '2013 Report to Congress Credit Rating Agency Independence Study' (2013) 35 <https://www.sec.gov/files/credit-rating-agency-independence-study-2013.pdf> accessed 4 April 2018.

[57] Moody's Analytics (n 57).

[58] Red rectangle indicates a registered NRSRO.

Other services in S&P means a service that is neither a part of credit rating activity nor an ancillary service.

According to Figure 4.2, S&P Capital IQ is a segment of S&P Global Market Intelligence rather than a part of S&P; in other words, S&P Capital IQ is not a part of NRSRO, while it provides a large amount of financial and analytical products and services. These products and services provided by S&P Capital IQ include 'market derived ratings, Credit Model, Global Credit Portal and Market Derived Signals (MDS) that are derived from a statistical model that evaluates credit default swaps.'[59]

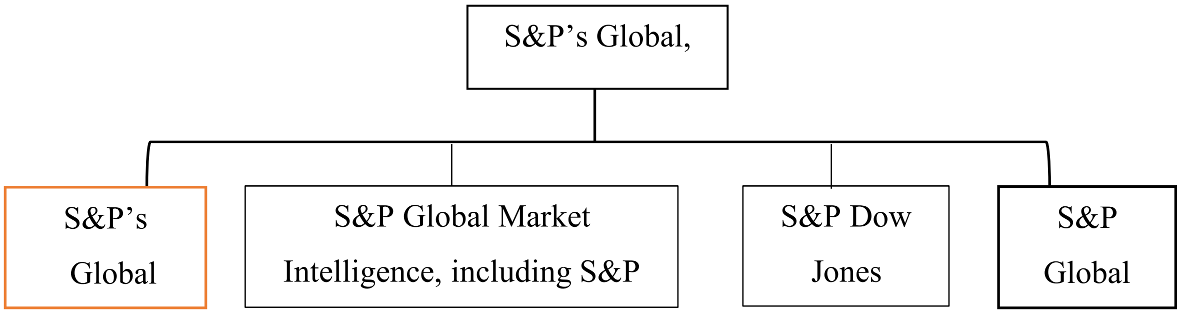

Figure 4.2 S&P's Global Inc. Organizational Structure[60]

Fitch provides 'core' products and services, ranging from credit rating services to the provision of feedback to structured financial transaction parties with respect to rating levels based on information provided by the transaction parties and their advisers.[61] Fitch defines *ancillary business* as 'any business other than the provision of independent analysis and rating and other opinions regarding a variety of risks in the financial markets'.[62] According to Figure 4.3, Fitch Solutions, as a non-NRSRO affiliate of Fitch Ratings and a subsidiary of Fitch Group that is the parent entity of Fitch Ratings, distributes Fitch Ratings research

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[59] The definition is cited from the SEC report. Its first resource cannot be found now from the S&P's official website because it is not part of NRSROs and thus does not need to report to the public. See SEC, '2013 Report to Congress Credit Rating Agency Independence Study' (n 58) 79.
[60] Red rectangle indicates registered NRSRO; S&P Global was McGraw Hill Financial, Inc. from 2013 to April 2016, and was McGraw Hill Companies prior to 2013).
[61] Fitch Ratings, 'Bulletin 30: Ancillary Business and Ancillary Services' (2018) 2 <https://www.google.co.uk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&ved=2ahUKEwiYz-WyraDhAhXuSxUIHccsBnIQFjACegQIAxAC&url=https%3A%2F%2Fwww.fitchratings.com%2Fsite%2Fdam%2Fjcr%3A001000e2-6fcc-425f-957e-ea77add52cdd%2FBulletin%252030%2520-%2520Ancillary%2520Business%2520and%2520Ancillary%2520Services.pdf&usg=AOvVaw0eQg82-SKpvtuqFn0aOGdZ> accessed 13 March 2019.
[62] ibid.

and ratings, financial data and other market-based content products.[63] Any ancillary services provided by both Fitch (Fitch Rating) and a division of Fitch Group should be separated from credit rating activity according to Fitch Group ‘s Firewall Policy.[64]

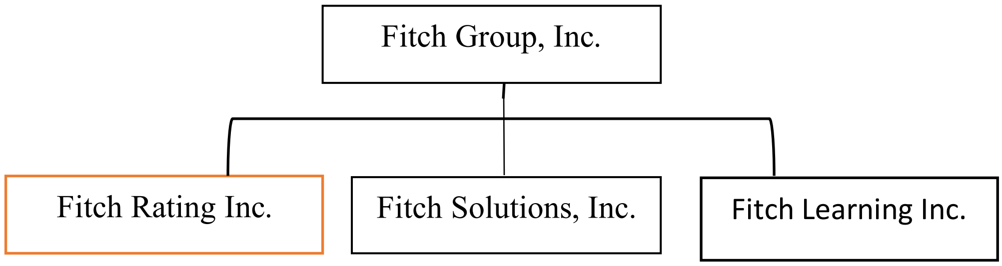

Figure 4.3 Fitch Group, Inc. Corporate Structure[65]

The existing regulations and measures against potential risk of ancillary include prohibiting CRAs from providing ancillary services and separation from rating services and ancillary services. However, as a response, parent company of CRAs tends to set up several subsidiaries so that other subsidiary can be responsible for ancillary services that may give rise to potential conflicts of interest with the rating service, but they are not subject to the prohibitions targeted to the CRAs. The current corporate system increases the opaqueness of relevant businesses between subsidiaries. Therefore, it remains difficult to manage this conflict by virtue of current countermeasures.

Apart from that, the boom of structured finance created huge profits in ancillary services relating to structured finance. However, issuers who purchased a large amount of ancillary services may conversely affect credit rating decisions. Especially when revenue of ancillary services accounts for a large proportion, CRAs are more likely to issue or maintain a favourable rating under that pressure. According to Figure 4.4, the revenue of Moody’s Analytics has been more than the revenue from ratings of structured financial products since 2006 and the gap between the revenue of Moody's Analytics and that from rating of corporate rating is comparably negligible.

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[63] SEC, ‘2013 Report to Congress Credit Rating Agency Independence Study’ (n 58) 29.
[64] Fitch Ratings, ‘Bulletin 30: Ancillary Business and Ancillary Services’ (n 63) 2-3.
[65] Red rectangle indicates registered NRSRO; Figure 4.3 adapted from Fitch Ratings, ‘2018 Form NRSRO Annual Certification’ (2018) <https://sec.report/Document/0001144204-18-063337/tv508564_nrsro-ex4.pdf> accessed 5 September 2018.

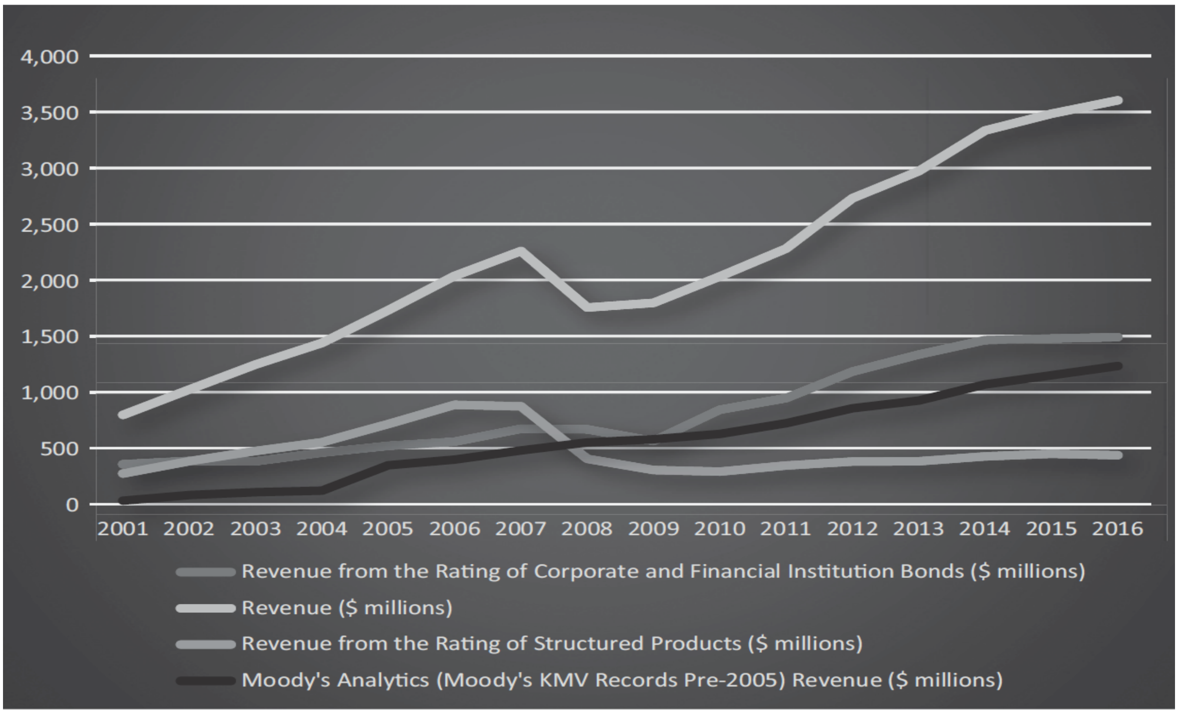

Figure 4.4 The Comparison of Revenue from the Rating Services and Revenue from the Ancillary Services in Moody's Corporation 2001–2016[66]

Last, but most important, the issuer-pays model gives rise to many different conflicts and has a huge influence on the whole credit rating industry. As Franklin Strier argues, the issuer-pays model created several kinds of conflicts of interest.[67]

c. Rating Shopping

Rating shopping creates sufficient incentives for CRAs to offer overly high ratings to their clients. At the individual level, rating shopping could be prevented by separation between rating sales staff and rating analysts or the separation between staff remuneration system and rating business.

Even though some regulatory proposals attempt to disclose all the ratings during the bidding stage — the issuer selects a potential CRA before it finally makes a decision — they have

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[66] Data collected the annual statements of Moody's Corporation from 2001 to 2016 and the figure from Daniel Cash, *Regulation and the Credit Rating Agencies: Restraining Ancillary Services* (Routledge 2019) 136.
[67] Franklin Strier, 'Rating the Raters: Conflicts of Interest in the Credit Rating Firms' (2008) 113(4) Business and Society Review 533, 537.

not been included in the regulation as yet.[68] Even so, the issuer would still have the freedom to choose one CRA whatever the standards the issuer considers. In addition, rating shopping is often associated with ancillary services, which increases the cost and difficulty of inspection and avoiding it.

Even though CRAs pay important attention to their reputation and try to keep the accuracy of their ratings, they will still feel adverse pressure from the whole industry. Rating shopping is a problem confronting the whole rating industry. If one CRA tries to counteract with it and refuses clients (issuers), it may suffer economic costs. For example, as a director in Dagong said, due to prioritizing professional integrity, the credit rating market shares held by Dagong changed from 40 per cent to 20 per cent.[69] That does not prove enough professional integrity on the part of Dagong, but implies the cost of refusing the rating shopping in the Chinese rating market. In short, the chance is low that rating shopping will be improved just by market self-discipline. Like ancillary services, rating shopping also stems from the issuer-pays model.[70] Besides, some researchers state that intense competition in the credit rating industry exacerbate rating shopping, both in the United States and China.[71] In short, the difficulty in regulation of rating shopping is that one has to realise that it is not an internal issue or the lack of incentive for the CRA itself, but a macro market failure under high concentration of the rating industry.

By comparing the existing regulation at the individual level and the agency level against conflicts of interests, it may be found that it is easier to manage conflicts at the individual level than conflicts at the agency level.

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[68] SEC, 'Fact Sheet: Strengthening Oversight of Credit Rating Agencies Open Meeting of the Securities and Exchange Commission' (2009) <https://www.sec.gov/news/press/2009/2009-200-factsheet.htm> accessed 20 December 2019

[69] National Business Daily [每日经济网], '156 Credit Rating Reports with AAA Issued by Dagong[大公国际一年评 156 个 AAA 成最高信用批发商]' (2018) <http://www.nbd.com.cn/articles/2011-08-18/590042.html> accessed 20 February 2018.

[70] Franklin argues that the issuer-pays model arises due to three discrete conflicts of interest in CRAs. See Strier (n 69) 537.

[71] Some United States scholars are opposed to lifting the NRSRO bar because they think competition will cause rating shopping. See, for example, John C. Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006) 299–300.
He MInhua discussed major problems still affecting Chinese CRAs, see Minhua He [何敏华], 'Some Remaining Issues in the Work of Credit Rating Short-Term Financing Securities [短期融资券信用评级工作存在的几个问题]' (2007) 14 China Finance [中国金融] 57.

4.3 The implementation of the Existing Regulations

In the United States, pursuant to Rule 17g-5(a), all the conflicts of interest listed in Exchange Act Rule 17g-5(b) are not allowed in an NRSRO, unless they are disclosed according to Exhibit 5 to form an NRSRO, or it establishes or maintains policies and procedures to manage such conflicts, or it achieves the additional requirements with regard to asset-backed securities transactions. In contrast to Rule 17g-5(a), an NRSRO is definitely prohibited from involving conflicts of interest listed in Rule17g-5(c). In addition, Rule 17g-6 addresses prohibited acts and practices of an NRSRO.

In the European Union, one of the main objectives of Regulation 2009 and Regulation 2013 is to address the conflicts of interest. Article 6 of Regulation 2009 was designed to ensure the independence of CRAs through imposing the obligation of internal controls on CRAs in order to avoid potentially collusive behaviours under the issuer-pays model. Regulation 2013 further prevents conflicts of interest by imposing requirements on shareholder structures of CRAs.

In China, the existing regulations require each CRA to establish internal controls and corporate governance in order to manage and avoid potential conflict of interest. The Interim Measures 2019 provides some relevant requirements, ranging from an avoidance system to the independence of CRAs.[72] Apart from that, the self-regulatory rules require that a CRA only initiate the rating process such as on-site inspection after its client has made the payment.[73]

In addition to statutory regulation, the corporate governance and internal control structure are more common and more flexible measures to manage conflicts of interest. In the United States, NRSROs are required to establish, maintain and enforce 'written policies and procedures to address and manage conflicts of interest'.[74]Based on the requirement, Moody's Code of Professional Conduct provides more restrictive and detailed requirements against possible conflicts of interest. Section 2.13(a) and (b) mention that employees related to the

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[72] Interim Measures for the Administration of the Credit Rating Industry [信用评级业管理暂行办法].

[73] Borong Liu [刘柏荣] and others, 'Securitisation [资产证券化法律实务指南]' (Zhong Lun Law Firm [中伦律师事务所] 2019) 36 <http://www.zhonglun.com/uploadfile/c/20190301_钱伯斯实务指南_资产证券化-中国（中英对照版）_第九稿.pdf> accessed 2 December 2019.

[74] Section 15E (h) of *The Securities Exchange Act of 1934* amended by *Credit Rating Agency Reform Act of 2006* and Rule 17g-5. See SEC, 'Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations' (n 6) 148.

rating process and his or her family member are not allowed to own securities at a rated entity (including derivatives of securities). Under section 2.13(c) and (d), all relationships that are beyond the ordinary course of business relationships are not permitted. Section 2.13(g) introduces the provision relating to gifts.[75] Fitch and S&P also have a relevant internal code to cope with possible conflicts of interest.[76] In China, big CRAs established internal codes to avoid possible conflicts of interest. For example, CCXI requires employees to avoid circumstance where they or their family member owns securities of rated entities and serve as an officer at rated entities.[77]

In the United States, according to the SEC's annual examination of NRSROs, the staff examined all the boards of directors or governing body, as well as independent directors, within NRSROs through interviews. In addition, all the relevant minutes and other documentation have been reviewed by the Office of Credit Ratings (hereafter 'OCR') which was created in 2012 pursuant to the Dodd–Frank Act. The SEC's 2018 annual examination shows that it has some identified improvements for many NRSROs with respect to awareness and compliance of applicable laws, even though there are still some weaknesses in NRSROs' performances.[78]

The weakness pointed out in the 2018 annual examination are as follows: First, there were vague policies that failed to address or manage conflicts of interest in one NRSRO.[79] Second, the current internal control structures in some NRSROs, in terms of managing conflicts of interest, were still weak.[80] Third, in terms of corporate governance, NRSROs should 'establish and maintain and enforce written policies and procedures reasonably designed to

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75 Moody's Investors Service, 'Moody Code of Professional Conduct' (2011) 2.13 <https://www.moodys.com/sites/products/ProductAttachments/Compliance/9-9-2011/MIS%20Code.pdf> accessed 30 December 2018.

76 Fitch Ratings, 'Fitch's Code of Conduct & Ethics' (2018) 3.3 <https://www.fitchratings.com/site/ethics> accessed 30 December 2018.; S&P, 'S&P Global Ratings Code of Conduct' (2018) <https://www.standardandpoors.com/en_US/delegate/getPDF?articleId=2017868&type=COMMENTS&subType=REGULATORY> accessed 30 December 2018. Further requirement could be found on S&P, 'Global 2018 Code of Business Ethics for Employees' (2018) 8 <https://www.standardandpoors.com/en_US/delegate/getPDF?articleId=2017855&type=COMMENTS&subType=REGULATORY> accessed 30 December 2018.

77 CCXI, 'Code of Conflicts of Interest and Avoidance Principle [中诚信国际利益冲突与回避管理制度]' section 3.1 and 3.2 <http://www.ccxi.com.cn/cn/Init/baseFile/1096/584> accessed 30 December 2018.

78 SEC, '2018 Summary Report of Commission Staff's Examination of Each Nationally Recognized Statistical Rating Organization' (2018) 10 <https://www.sec.gov/nrsro-summary-report-2018_0.pdf> accessed 8 March 2019.

79 ibid 20.

80 ibid 20-21.

prevent the misuse of material non-public information (hereafter 'MNPI')'[81], but one NRSRO did not apply MNPI to a new non-employee, a non-independent director.[82] Apart from that, one NRSRO did not fulfil its oversight duties pursuant to section 15E(t)(3)[83].[84] The independent directors lacked awareness of information relating to internal controls, conflicts of interest, ratings determination and employee compensation.[85] Thus, the transparency and information disclosure for independent directors within this NRSRO were not fully completed according to the requirement. In practice, both the NRSRO and the independent directors lacked activism and activity to enforce the requirement of transparency. The independent directors lacked activism to make reasonable and efficient inquires pertaining to significant arrangements during the NRSRO's operation.

However, given that the number of NSRSOs,[86] the conclusion could be drawn that only a minority of NRSROs had been examined for their non-compliance with legal requirements, while most of them had fulfilled their duties.

According to the SEC annual examination of 2018, one NRSRO failed to design adequate procedures to separate rating activities from marketing activities. Another NRSRO's procedures designed to separate rating activities from sales and marketing activities were still weak. Besides, NRSRO personnel did not always adhere to the procedures regarding the separation of sales and rating activities.[87]

In the European Union, according to the 2018 annual investigation of ESMA, the current procedures of CRAs did not fully conform to regulatory requirements.[88] Some CRAs lacked

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[81] Section 15E(g) of The Securities Exchange Act of 1934 amended by Credit Rating Agency Reform Act of 2006 and SEC Rule 17g-4. See SEC, 'Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations' (n 6) 107.
[82] SEC, '2018 Summary Report of Commission Staff's Examination of Each Nationally Recognized Statistical Rating Organization' (n 55) 20.
[83] It provides for duties of board of directors. See Section 15 E(t)(3) of *The Securities Exchange Act of 1934* amended by Credit Rating Agency Reform Act of 2006.
[84] SEC, '2018 Summary Report of Commission Staff's Examination of Each Nationally Recognized Statistical Rating Organization' (n 55) 29.
[85] ibid.
[86] In 2019, the incumbent ten NRSROs are as follows: A.M. Best Rating Services, Inc. ("AMB"), DBRS, Inc. ("DBRS"), Egan-Jones Ratings Company ("EJR"), Fitch , HR Ratings de México, S.A. de C.V. ("HR"), Japan Credit Rating Agency, Ltd. ("JCR"), Kroll Bond Rating Agency, Inc. ("KBRA"), Moody's Investors Service, Inc. ("Moody"), Morningstar Credit Ratings, LLC ("MCR"), S&P Global Ratings ("S&P").
[87] SEC, '2018 Summary Report of Commission Staff's Examination of Each Nationally Recognized Statistical Rating Organization' (n 55) 20–1.
[88] ESMA, 'ESMA's Supervision – 2018 Annual Report and 2019 Work Programme' (2018) ESMA80-199–273 <https://www.esma.europa.eu/sites/default/files/library/msp_ar2018_and_wp2019.pdf> accessed 20 April 2020.

effective internal control structures to manage conflicts of interest. More specifically, in corporate governance, some registered CRAs in ESMA had not established an effective board of directors to avoid potential conflicts of interest. [89]

To sum up, even though there are numerous scenarios that may cause conflicts of interest at the individual level, the current regulation and corporate governance have an effect on the mitigation of existing conflicts. Given humanity's capacity for selfishness, more and novel kinds of conflict of interest from an individual perspective may arise. To better update the potential new issues, first, regulators should ensure disclosure and transparency. To cope with such issues flexibly, CRAs incorporate corporate governance and draft specific internal codes annually. However, according to the SEC 2018 Summary Report, the internal control codes of both larger and smaller NRSROs have weaknesses. In terms of governance, NRSROs lack disclosure and transparency, and independent directors thus lack sufficient information to engage in corporate governance. Independent directors also lack initiatives to fulfil their duties.[90]

4.4 Critical Assessment

Many proposals tried to reform the issuer-pays model so as to better avoid and manage conflicts of interests. For example, European Commission proposed to establish a publicly funded EU CRA. The publicly funded EU CRA could adopt a more measured approach to ratings and make more proper political judgment; nevertheless, the concern of this proposal is about the independence of this publicly funded EU CRA, and this proposal is likely to reinforce the over-reliance on credit ratings instead of reducing it. [91] Furthermore, another EU report discusses the possibility of a fully independent non-public European Credit Rating Foundation. [92] This independent non-public European Credit Rating Foundation was financed by the 'financial community in the form of credits that will yield some interest payment' instead of public fund.[93] By contrast, even though this proposal improved the independency of former one, it seems pessimistic to the likelihood of the success of this project, not only because it is uncertain whether the new credit rating foundation is or not

[89] ibid 23–4.
[90] SEC, '2018 Summary Report of Commission Staff's Examination of Each Nationally Recognized Statistical Rating Organization' (n 80).
[91] House of Lords European Union Committee, 'European Union Committee 21st Report. Sovereign Credit Ratings: Shooting the Messenger?' (Authority of the House of Lords 2011) HL Paper 189, 29.
[92] Rapporteur: Wolf Klinz, 'Report on Credit Rating Agencies: Future Perspectives' (European Parliament Committee on Economic and Monetary Affairs 2011) A7-0081/2011, 7 and 13-4.
[93] House of Lords European Union Committee (n 91).

able to survive from market competition, but also because the potential conflicts of interests and problems are similar to the current CRAs.[94] In other words, the current reform attempts related to business model seems uncertain. Before continuing to deal with conflicts of interest, it is worth noting whether or not changing the issuer-pays model is the optimal option for rating quality.

The issuer-pays model has a huge influence on the whole credit rating industry. At present, even though CRAs still provide subscription services, 90 per cent to 95 per cent of revenue is derived from fees paid by issuers.[95] In the initial period of the credit rating industry, the business model had been the subscriber-pays model before 1969.[96] In 1970, Moody's and Fitch began to shift their business model from the subscriber-pays to the issuer-pays model. Later in 1974, S&P began to charge issuers.[97] One rational argument for the adoption of the issuer-pays model is that the subscriber-pays model cannot meet the new demand of market expansion and afford the cost of the rating activity.[98] There are four reasons for this shift from the subscriber-pays model to issuer-pays model. First of all, after the collapse of Penn Central, more and more issuers realized the importance of credit rating in rebuilding investor confidence in the bonds market. [99] In addition, on the heels of the liquidity crises, the 1970 Penn Central default on USD 82 million in commercial paper drew attention to the credit risk.[100] Therefore, issuers had incentives to actively seek ratings so that they could be more likely to be trusted by investors. Second, the development of photocopy technology leads to the fact that credit ratings are easily spread among both subscribers and non-subscribers at a lower cost. The revenue of CRAs has consequently decreased, and in order to meet the demand of the new market, CRAs have had to adjust their business model.[101] Third, in the 1970s, the SEC attempted to maintain the stability of the financial market via CRAs, and thus created NRSROs. As discussed in Chapters 2 and 3, these regulations based on NRSROs objectively grants a special market status to NRSROs. Apart from that, these

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[94] ibid 29-30; Rapporteur: Wolf Klinz (n 92) 13-4.

[95] Christopher R. Dyess, 'Credit Rating Agency Review Board: The Challenges and Implications of Implementing the Franken-Wicker Amendment to Dodd-Frank' (2015) 8(1) The Journal of Business, Entrepreneurship & the Law 79, 89 <https://digitalcommons.pepperdine.edu/cgi/viewcontent.cgi?referer=https://www.google.co.uk/&httpsredir=1&article=1120&context=jbel> accessed 18 December 2018.

[96] Ulrich G. Schroeter, 'Credit Ratings and Credit Rating Agencies' in Gerard Caprio and Douglas W. Arner (eds), *Handbook of key global financial markets, institutions, and infrastructure* (Academic Press 2013) 383.

[97] Lawrence J. White, 'The Credit Rating Industry: An Industrial Organization Analysis' [2001] New York University, Law & Economics Research Paper Series 12.

[98] Raquel García Alcubilla and Francisco Javier Ruiz del Pozo (n 49) 248.

[99] Daniel Cash, *Regulation and the Credit Rating Agencies: Restraining Ancillary Services* (Routledge 2019) 97.

[100] Lawrence J. White (n 97).

[101] ibid; Daniel Cash (n 66) 101-3.

regulations generated incentives for bond issuers to purchase rating services from NRSROs because if an issuer obtained a positive rating issued by a NRSRO it would be credible and thus obtain more finance. Fourth, the function of credit ratings in pricing securities has a more important effect on issuers compared to investors. Therefore, CRAs played a significant role in structured financial products in the later financial crisis of 2008. In a nutshell, the issuer-pays model was adopted at the appropriate time when both the market and regulator attached importance to CRAs. Apart from that, the extension of other services related to rating services, such as pricing securities and designing structured financial products, generated consistent dynamics for issuers. As a result, the role of the issuer-pays model cannot be changed readily.

4.4.1 The Failure of the Reputation Mechanism

CRAs have not been regulated for decades. During that period, the credit rating industry self-regulated through the reputation mechanism. The 'reputation mechanism operates on the credit rating industry to solve problems of information asymmetry.'[102] In essence, the reputation mechanism could be regarded as an integral part of private ordering.[103] In the initial period of the credit rating industry, the business model had been the subscriber-pays model before 1969. The dominant theory in that period was the reputation mechanism. The reputation mechanism operates in a simple way: CRAs accumulate reputation through being monitored by market participants, based on the good records of credit ratings. Good records bring good reputation and CRAs thus gain more business. In this regard, CRAs have incentives to behave well and keep accurate rating records so that investors can believe them and purchase their rating services. Nevertheless, the recent financial crisis proved that the reputation mechanism failed to incentivize CRAs to ensure the rating quality, especially in structured finance.

The reputation mechanism does not work well all the time. The mechanism dates back to the Middle Ages in Europe where the revival of trade gave a rise to burgeoning institutions that

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[102] Paul Lasell Bonewits, 'Implications of Reputation Economics on Regulatory Reform of the Credit Rating Industry' (2010) 1(2) William & Mary Business Law Review, 391 <https://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1011&context=wmblr> accessed 8 September 2018.

[103] Barak D. Richman, 'Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering' (2004) 104(8) Columbia Law Review 2328, 2367.

underpinned commerce.[104] During this period, most informal reputation mechanisms were gradually replaced with novel and diverse formal ones, which were based on the legal infrastructure that supported commercial contracts and protected private property. The formal reputation mechanism extended the geographical trade area and reached beyond the social constraints which traders neither knew well nor with whom they had biological and social ties.[105] However, with the further development of commerce, the shortcoming of the reputation mechanism is gradually exposed. In the middle of the nineteenth century in America, as the grains market and construction of the railroad network among Chicago's hinterlands grew, farmers transported wheat changing from packaging it into sacks, to taking it out and pouring it into elevators and railroad cars.[106] This caused wheat from various farms to be mixed, and consumers thus could no longer distinguish from which farm which adulterated wheat was from.[107] Some farmers adulterated their wheat, secure in the knowledge they could not be accountable for this adulteration.[108] To grapple with the problem, the Chicago Board of Trade proposed one solution, and that was that the way to measure wheat was to replace the volume with the weight. However, this solution was futile, and even had adverse effects, because farmers had less incentives to clean the wheat.[109] Later, an inspection and regulation system designed by the Illinois state government replaced the reputation mechanism of individual farmers.

As seen above, there are two obvious shortcomings with regard to the reputation mechanism. For One thing, when targeted information asymmetry is too complex, the reputation mechanism may not work well. As can be seen from the American wheat scenario, when the particular stage or procedure and its responsible party that result in the final negative outcome cannot be confirmed, the reputation mechanism will not work well. Back to the credit ratings: the reputation mechanism proved ineffective when CRAs failed to properly assess structured financial products. Credit ratings related to structured finance aims to reduce the information asymmetry between investors and the rated structured financial

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104 Christopher McKenna and Rowena Olegario, 'Corporate Reputation and Regulation in Historical Perspective' in Timothy G. Pollock and Michael L. Barnett (ed), *The Oxford Handbook of Corporate Reputation* (Oxford University Press 2012) 261.
105 Douglass C. North and Robert Paul Thomas, *The Rise of the Western World: A New Economic History* (Cambridge University Press 1973).
106 Christopher McKenna and Rowena Olegario, 'Corporate Reputation and Regulation in Historical Perspective' in Timothy G. Pollock and Michael L. Barnett (ed), *The Oxford Handbook of Corporate Reputation* (Oxford University Press 2012) 262–63.
107 ibid.
108 ibid.
109 Naomi R Lamoreaux and Peter Temin Daniel M. G. Raff, 'Beyond Markets and Hierarchies: Toward a New Synthesis of American Business History' (2003) 108(2) The American Historical Review 414-15.

products. However, the structured financial products are too complex to be assessed properly. Even though it has been recognized that CRAs had underestimated the risk in structured financial products, it is still hard to determine who should be the principal responsible party of the collapse of structured finance (such as an issuer of the underlying asset, a creator of structured debt instrument or a CRA). That information can efficiently flow among market participants is the prerequisite of the effectiveness of reputation mechanism.[110] Therefore, when the rated entities are overly complex, the limited information flow cannot ensure the reputation mechanism to work well.

For another, companies are sometimes more willing to pursue short-term gains in the cost of reputation. A good reputation cannot be established in the short term. The reputation mechanism utilizes the threat of bad reputation to deter individual misconduct. However, when an individual has a short-term fraudulent motive the fraudulent conduct may at the same time create huge profits, the incentive of huge profits is more likely to suppress the threat of a bad reputation. As can also be seen from the US wheat example cited above, the ineffectiveness of the reputation mechanism is apparent when the one-time transaction can create enough profits. Rating structured finance quickly provides large amounts of profits for CRAs as well. Even though CRAs are unable to assess the structured financial products, they still choose to provide such relevant services in the cost of their reputation. Besides, fierce competition may force CRAs to focus on the short-term profits.[111] As will be analysed in Chapter 5, the oligopolistic market structure further accelerates the failure of the reputation mechanism. In short, the key to the failure of the mechanism is structured finance.

4.4.2 Structured Finance

Structured finance can be regarded as 'a form of financial intermediation, based upon securitization technology'.[112] There are three characteristics to structured finance: First, it involves the pooling of assets and selling the right to claim on the cash flows backed by these assets to investors. The underlying backed assets include cash instruments (such as residential mortgages) and synthetic exposures (such as credit default swaps). Second, these cash flows from the backed underlying assets are repackaged into several tranches, usually

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[110] Barak D. Richman (n 103) 2367.

[111] Lori Qingyuan Yue and Paul Ingram, 'Industry Self-Regulation as a Solution to the Reputation Commons Problem: The Case of the New York Clearing House Association' in Timothy G. Pollock and Michael L. Barnett (eds), *The Oxford Hankbook of Corporate Reputation* (Oxford University Press 2012) 283.

[112] Bank for International Settlements, 'The Role of Ratings in Structured Finance: Issues and Implications' (2005) 4 <https://www.bis.org/publ/cgfs23.pdf> accessed 10 October 2019.

including senior, mezzanine and junior tranches. Each tranche is rated by CRAs. A senior tranche with the highest rating often has the lowest interest, while a junior tranche has the lowest rating and provides the highest interest. A senior tranche is paid first by the interest and principal payment from the underlying collateral pool, and the mezzanine tranche then receives the additional principal amount and interest, and the junior is the last one to be addressed. Once the underlying collateral assets default, the junior tranche absorbs the initial losses first, followed by the mezzanine tranche, which absorbs the additional losses, followed by the senior tranche.[113] Third, is the 'delink[ing of] the credit risk of the collateral asset pool from the credit risk of the originator, usually through use of a finite-lived, standalone special purpose vehicle'.[114]

Unlike the rating of corporate bonds, structured financial products are structured to obtain a targeted rating by the pooling and tranching of assets. CRAs play a dual role in the creation and design of these structured financial products. For one thing, CRAs provide credit assessments underlying collateral assets during the pooling process.[115] For another, CRAs engage in designing the structures of these financial products and often provide structure advice during the tranching process.[116] The rating for structured financial products has an *ex ante* character, because each tranche of structured financial product is designed for a particular rating before CRAs are involved in the creation and design process.[117] When a credit rating is sought, CRAs need to design the proportion of underlying collateral assets according to their credit assessments for each tranche so that each tranche can get the targeted rating as envisaged beforehand.[118]

As a result, structured finance is complex and opaque, but most investors misunderstood the credit rating of structured financial products prior to the financial crisis. On the other hand, the role of CRAs during the whole process lacked independence. CRAs provide structure advice in accordance with the need for a credit rating for each tranche which was designed beforehand by issuers. The complexity of structured finance acts as a veil for this conflict of interest. *C*onflicts of interest in structured finance exacerbated to a large extent the rating

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[113] Technical Committee of the International Organizaation of Securities Commissions, 'The Role of Credit Rating Agencies in Structured Finance Markets Final Report' (2008) 6 <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf> accessed 10 October 2018.
[114] Bank for International Settlements (n 112).
[115] Amadou N. R. Sy, 'The Systemic Regulation of Credit Rating Agencies and Rated Markets' (International Monetary Fund 2009) IMF Working Paper, WP/09/129, 15.
[116] ibid.
[117] Technical Committee of the International Organization of Securities Commissions (n 1) 5.
[118] ibid.

failure during the financial crisis. Some researchers believe that the issuer-pays model escalated the conflicts of interest, especially in structured finance, and thus attempted to reform the model to manage the severe conflicts in structured finance.

Under the issuer-pays model, the revenue of CRAs depends on the issuer, and CRAs are likely to provide favourable rating for their clients, namely issuers. The inherent drawback also exists in the traditional corporate bonds rating. If one thus assumes that the inherent limit finally brings about conflicts of interest, even a rating failure or delay, it should have same effect on both traditional corporate bonds and structured finance. However, as the analysis below based on Tables 4.1 and 4.2 and Figures 4.5 and 4.6 below indicate, the credit rating is more stable in corporate bonds rather than in structured finance.

Table 4.1 The Comparison of S&P Annual Global Corporate and Structured Finance One-year Default Rates from 2000 to 2017[119]

Year	Global Annual Corporate Default Rates (%)							Global Structured Finance One-year Default Rates (%)							
	AAA	AA	A	BBB	BB	B	CCC/C	AAA	AA	A	BBB	BB	B	CCC	CC
2000	0.00	0.00	0.27	0.37	1.16	7.70	35.96	0.00	0.00	0.00	0.07	0.47	1.85	4.55	6.25
2001	0.00	0.00	0.27	0.34	2.96	11.53	45.45	0.01	0.00	0.09	0.42	0.65	2.79	31.91	15.00
2002	0.00	0.00	0.00	1.01	2.89	8.21	44.44	0.00	0.04	0.14	0.52	1.87	8.27	29.55	13.64
2003	0.00	0.00	0.00	0.23	0.58	4.07	32.73	0.00	0.00	0.07	0.52	0.92	2.29	34.78	15.69
2004	0.00	0.00	0.08	0.00	0.44	1.45	16.18	0.00	0.00	0.00	0.14	0.72	2.19	14.72	11.11
2005	0.00	0.00	0.00	0.07	0.31	1.74	9.09	0.00	0.00	0.00	0.06	0.19	1.33	11.44	23.53
2006	0.00	0.00	0.00	0.00	0.30	0.82	13.33	0.00	0.00	0.00	0.08	0.26	0.47	17.13	18.28
2007	0.00	0.00	0.00	0.00	0.20	0.25	15.24	0.01	0.06	0.11	0.61	2.37	1.41	22.22	24.18
2008	0.00	0.38	0.39	0.49	0.81	4.09	27.27	0.33	0.66	1.04	2.00	4.78	11.77	57.15	27.11
2009	0.00	0.00	0.22	0.55	0.75	10.94	49.46	0.22	1.37	2.88	5.71	9.14	16.03	49.04	64.57
2010	0.00	0.00	0.00	0.00	0.58	0.86	22.62	0.14	0.50	0.71	1.84	2.59	5.25	16.08	38.30
2011	0.00	0.00	0.00	0.07	0.00	1.67	16.30	0.10	0.12	0.07	0.43	1.02	5.46	13.46	51.93
2012	0.00	0.00	0.00	0.00	0.30	1.57	27.52	0.04	0.13	0.05	0.32	0.66	1.46	19.59	44.79
2013	0.00	0.00	0.00	0.00	0.10	1.64	24.50	0.00	0.05	0.07	0.22	0.64	1.32	8.90	37.59
2014	0.00	0.00	0.00	0.00	0.00	0.78	17.42	0.00	0.04	0.00	0.02	0.17	1.33	7.43	28.08
2015	0.00	0.00	0.00	0.00	0.16	2.40	26.51	0.00	0.11	0.08	0.08	0.48	1.43	8.89	27.38
2016	0.00	0.00	0.00	0.06	0.47	3.70	33.17	0.00	0.27	0.07	0.19	0.22	1.26	5.91	30.58
2017	0.00	0.00	0.00	0.00	0.08	0.98	26.23	0.01	0.08	0.23	0.36	1.11	1.38	5.64	17.17

119 Data collected from Tables 3 of S&P, '2017 Annual Global Corporate Default Study and Rating Transitions' (2018) 8-9 <https://www.spratings.com/documents/20184/774196/2017+Annual+Global+Corporate+Default+Study/a4cffa07-e7ca-4054-9e5d-b52a627d8639> accessed 19 January 2019, and Table 10 of S&P, '2017 Annual Global Structured Finance Default Study and Rating Transitions' (2018) 38-9 <https://www.spratings.com/documents/20184/86957/2017AnnualGlobalStructuredFinanceDefaultStudyAndRatingTransitions_052918.pdf> accessed 20 February 2019.

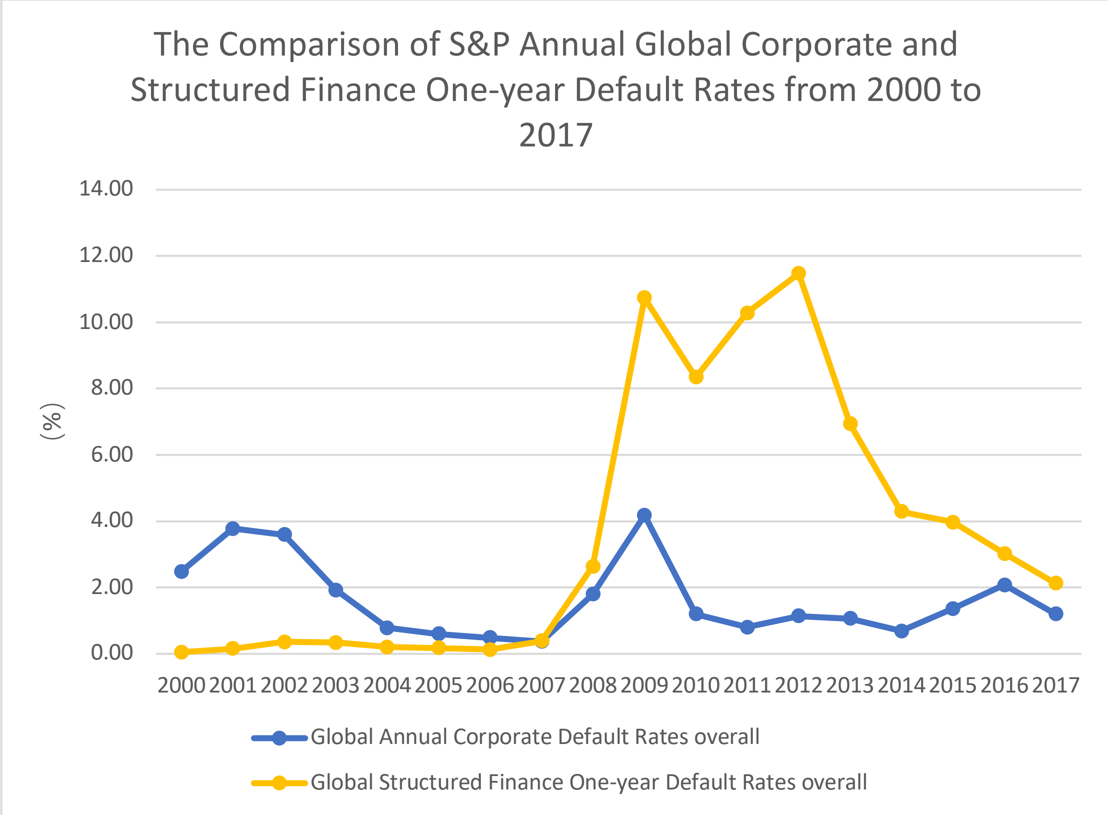

Figure 4.5 Comparison of S&P Annual Global Corporate and Structured Finance One-year Default Rates from 2000 to 2017[120]

The numbers from the tables and figures serve to demonstrate the following:

a. According to Table 4.2 and Figure 4.5, the overall default rates of traditional corporate bonds rating are apparently lower than the overall default rates of structured finance ratings, even during financial crisis. More specifically (Table 4.1), most of the default rates of each various-grade rating in corporate bonds are lower than their counterparts in structured finance. Since the financial crisis of 2007, defaults have even been found in structured financial bonds with AAA ratings and, needless to say, bonds with AA or A ratings have higher default rates. By contrast, the corporate bonds with a AAA rating appeared to no defaults from 2000 to 2017, and even bonds with AA or A ratings appeared to have comparatively lower default rates. By comparing each column of the same ratings between corporate default rates and structured finance default rates, each default rate of corporate bonds is lower than the counterpart in structured finance bonds. This shows that the credit rating inflation was obviously in the structured finance rating. The lower default rates in each column of corporate bonds implies the stability of corporate ratings.

[120] Data collected from Table 4.2.

Table 4.2 Comparison of IG Default Rates and SG Default Rates in S&P Global Annual Corporate and One-year Structured Finance Credit Ratings from 2000 to 2017[121]

	Global Annual Corporate Default Rates (%)			Global Structured Finance one-year Default Rates (%)		
Year	Overall	IG default rates	SG default rates	Overall	IG default rates	SG default rates
2000	2.48	0.24	6.23	0.05	0.00	1.18
2001	3.78	0.23	9.87	0.16	0.04	2.76
2002	3.59	0.42	9.50	0.36	0.05	5.66
2003	1.92	0.10	5.07	0.34	0.06	4.17
2004	0.78	0.03	2.02	0.20	0.02	2.24
2005	0.60	0.03	1.50	0.17	0.01	1.77
2006	0.48	0.00	1.19	0.13	0.01	1.24
2007	0.37	0.00	0.91	0.39	0.12	3.00
2008	1.80	0.42	3.69	2.64	0.70	15.97
2009	4.18	0.33	9.90	10.74	1.54	34.58
2010	1.20	0.00	3.01	8.34	0.53	17.50
2011	0.80	0.03	1.84	10.28	0.14	21.41
2012	1.14	0.00	2.58	11.47	0.10	23.06
2013	1.06	0.00	2.30	6.93	0.07	14.53
2014	0.69	0.00	1.43	4.29	0.01	9.23
2015	1.36	0.00	2.76	3.97	0.06	8.75
2016	2.08	0.03	4.21	3.02	0.12	6.91
2017	1.20	0.00	2.44	2.12	0.15	4.94

b. According to Figure 4.5 and Figure 4.6, the overall default rates in structured finance have remained high from 2008 to 2012, while the corporate default rates peaked in 2009 and then reverted down to the same levels as before. This implies that, to some extent, structured finance bonds are more vulnerable than corporate bonds. Apart from that, the corporate default rates remain stable before and after a financial crisis, which implies the accuracy and validity of credit ratings in corporate bonds.

[121] IG means investment grade; SG means speculative grade; Data collected from Tables1 of S&P, '2017 Annual Global Corporate Default Study and Rating Transitions' (n 119) 3-4. and Table 10 of S&P, '2017 Annual Global Structured Finance Default Study and Rating Transitions' (n 119) 38-9.

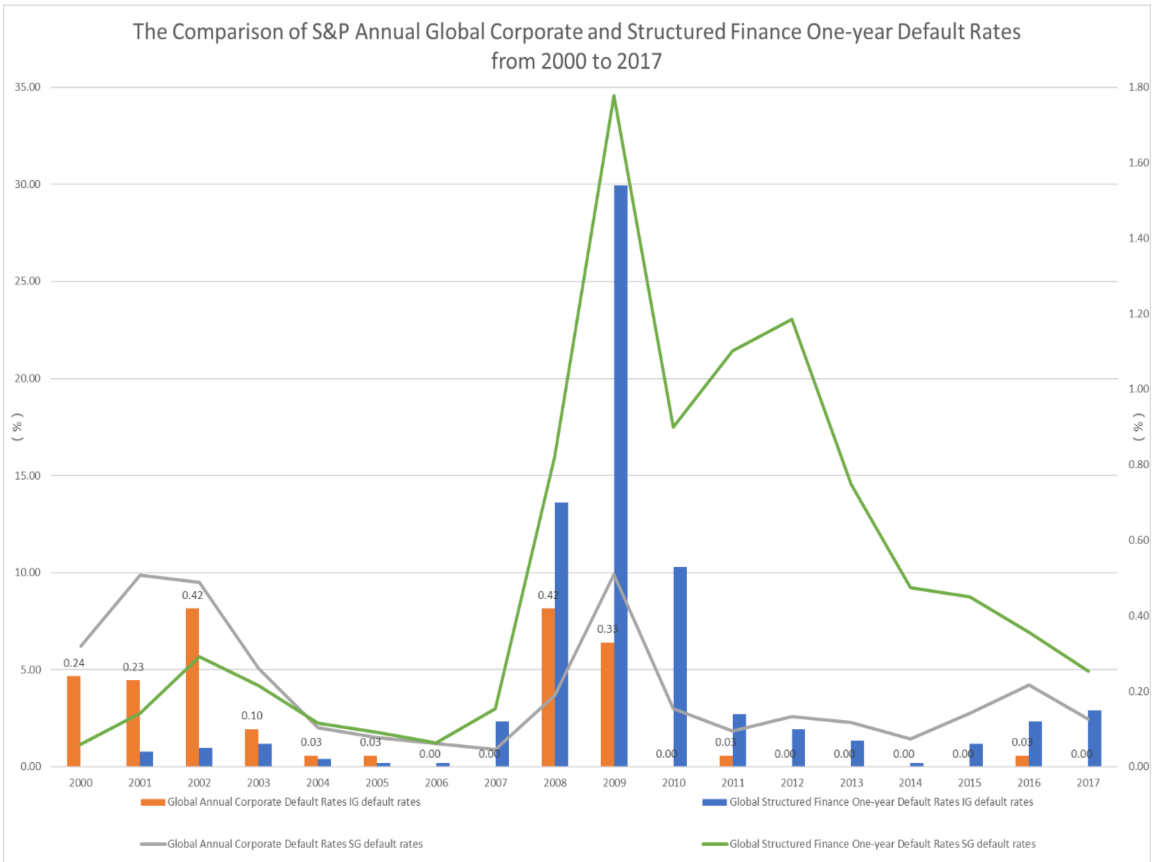

Figure 4.6 Comparison of IG Default Rates and SG Default Rates in S&P Global Annual Corporate and One-year Structured Finance Credit Ratings from 2000 to 2017[122]

As can be seen from the numbers and lines in Tables 4.1,4.2 and Figures 4.5, 4.6, the default rates in structured finance after the aftershocks of the financial crisis were still distinctly higher than those before the financial crisis. Besides the vulnerability of structured finance, one of the possible explanations is that CRAs rethought and confronted the real default risks of structured finance during the financial crisis and, after that, the real default rates of structured finance have been disclosed and revealed.

Simply put, corporate bonds rating presents lower defaults rates and stronger stability than the credit rating in structured finance. These obvious differences contradict the assumption made before that if the issuer-pays model leads to serve conflicts of interest, that should have the same effect on both corporate ratings and structured finance ratings. Therefore, that implies the inherent limit of the issuer-pays model itself that it does not contribute sufficiently to the severe conflicts of interest or, at least, the mere issuer pays has no severe

[122] IG means investment-grade; SG means speculative-grade. Data collected from Table 4.2.

effect on structured finance or, at least, the issuer-pays model alone cannot lead to severe failure of structured finance.

More importantly, the rating in structured finance generated huge amounts of revenue, which provides sufficient incentives for CRAs to issue ratings regardless of the quality of these ratings. The CDO[123] issuance alone boomed from USD 157 billion to USD 552 billion from 2004 to 2006.[124] The amount of revenue of CRAs with respect to CDO and RMBS[125] increased rapidly from 2002 to 2006 and business relating to structured finance became the main source.[126] For example, according to Moody's annual report, the rating of structured financial products increased substantially by 87 per cent from 2003 to 2006, which occupied more than half of the whole revenue in 2006.[127] Thus, the conclusion that can be drawn is that the special traits of structured finance stimulates the inherent incentive under the issuer-pays model for CRAs. In a nutshell, the credit rating related to structured finance is mainly attributed to the collapse of the financial market.

4.4.3 Proposals for Structured Finance Instead of a Business Model

In terms of the issuer-pays model, the model can be regarded as the current typical conflicts of interest. The possibility of changing the issuer-pays model is being discussed.[128] However, neither the European Union nor the United States has changed this model, even though they are fully aware of it.[129]

Some researchers, especially in China, called for a change of business model from the issuer-pays model to the investor-pays model after the financial crisis.[130] The reasonable part of

[123] A collateralized debt obligation (hereafter 'CDO') is a kind of asset-backed security.
[124] Deryn Darcy, 'Credit Rating Agencies and the Credit Crisis: How the Issuer Pays Conflict Contributed and What Regulators Might Do about It.' (2009) 2 Columbia Business Law Review 605, 638.
[125] Residential mortgage-backed securities (RMBS) are a type of mortgage-backed debt obligation created from residential debt, such as mortgages, home-equity loans and subprime mortgages.
[126] SEC, '2008 Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies' (2008) 10 <https://www.sec.gov/news/studies/2008/craexamination070808.pdf> accessed 19 January 2019.
[127] John Patrick Hunt, 'Credit Rating Agencies and the Worldwide Credit Crisis: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement' (2009) 2009 Columbia Business Law Review 109, 173.
[128] Mohammed B. Hemraj, 'The Role of Public Policy in Regulating Credit Rating Agencies in the US and EU: Potential Drawbacks' (2015) 36(9) The Company Lawyer 288, 289.
[129] ibid.
[130] Yuhui Wu [吴育辉] and others, '"Investor-Paid" vs. "Issuer-Paid", Which Credit Rating Quality Is Higher? ["投资人付费"vs."发行人付费"，谁的信用评级质量更高?]' (2020) 475 Journal of Financial Research [金融研究] 145-6.

this proposal is that the Chinese market has not formed the oligopolistic structure and the regulatory limits in structured finance, and the resistance against the change is lower. However, the proposal for a simple investor-pays model ignores the influence of larger investors.

To cope with the issuer-pays model, as Lynch proposed, one possible solution is that credit ratings be paid by the public, provided that '(1) A taxpayer-funded public institution could be created to conduct risk analysis; (2) The government could pay selected private CRAs for their services; (3) Tax incentives could be provided to CRAs who provide accurate ratings'.[131] The proposal further develops the business model change, and it may avoid such conflicts involving the issuer-pays model. The problem is how to determine or ensure the accuracy of rating. Another proposal is to establish an international non-profit CRA that is designed to conduct sovereign-risk assessment and provide sovereign credit ratings. This aims to establish transparent and legitimate governance structures. The inevitable problem is the funding source. As assumed, funding sources include governments, companies, non-governmental organisations, foundations and private donations. The operation and maintenance would require USD 400 million.[132] The overhead costs and unstable funding source are the apparent issues. For example, European Commission proposed to establish a publicly funded EU CRA. The publicly-funded EU CRA could adopt a more measured approach to ratings and make more proper political judgment; nevertheless, the concern of this proposal is about the independence of this publicly-funded EU CRA, and this proposal is likely to reinforce the over-reliance on credit ratings instead of reducing it.[133] Furthermore, another EU report discusses the possibility of a fully independent non-public European Credit Rating Foundation.[134] This independent non-public European Credit Rating Foundation was financed by the 'financial community in the form of credits that will yield some interest payment' instead of public fund.[135] By contrast, even though this proposal improved the independency of former one, it seems pessimistic to the likelihood of the success of this project, not only because it is uncertain whether the new credit rating foundation is or not able to survive from market competition, but also because the potential

[131] Timothy E. Lynch, 'Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment' (2009) 59(2) Case Western Reserve Law Review 227, 292-304.
[132] Bertelsmann Foundation, 'Bertelsmann Foundation Releases Blueprint for INCRA – An International Non-Profit Credit Rating Agency' (18 April 2012) <https://newsletter.biia.com/bertelsmann-foundation-releases-blueprint-for-incra-—-an-international-non-profit-credit-rating-agency> accessed 20 January 2019.
[133] House of Lords European Union Committee (n 91) 29.
[134] Rapporteur: Wolf Klinz, 'Report on Credit Rating Agencies: Future Perspectives' (European Parliament Committee on Economic and Monetary Affairs 2011) A7-0081/2011, 7 and 13-4.
[135] House of Lords European Union Committee (n 91).

conflicts of interests and problems are similar to the current CRAs.[136] In other words, the EU reform proposals related to business model seems uncertain.

The discussion of all kinds of conflicts of interest aims to manage or avoid the potential misconduct of CRAs. The three assumed reasons causing conflicts of interest in structured finance under the issuer-pays model, include the inherent limits of this model, the huge profit incentive generated from structured finance and the oligopolistic structure of the big three CRAs. The evidence to exclude the first one is that the shift of the business model from the investor-pays model to issuer-pays model gave rise to conflicts in structured financial products rather than the traditional corporate bonds.[137] At least, the conflicts of interest with respect to credit rating in traditional bonds needs to be improved, while the counterpart in structured finance needs to be solved. The reputation theory proved the inadequacies of the second reason.

As discussed above, the root of the problem focuses on structured finance. In China, the PBOC, CBRC and Ministry of Finance issued Notice of the People's Bank of China, the China Banking Regulatory Commission and the Ministry of Finance on Relevant Matters Concerning Further Expanding the Pilot Securitization of Credit Assets, which forbids the re-securitisation and synthetic securitization in a certain period of time.[138] In practice, re-securitisation and synthetic securitization have thus far not been allowed to be traded.[139] Apart from that, other structured financial products are also strictly controlled by relevant financial regulators and only such structured financial products created in a simple way could be allowed to be traded.[140] This reform is not only designed to be in line with the goal of serving the productive economy, but also avoids conflicts of interest in structured finance. The benefits of this reform are evident: first, it to a large extent solves the incentive problem that motivated CRAs since much profit stemmed from rating structured financial products, even though the relevant businesses for CRAs decreased largely. Second, the prohibition on re-securitization and synthetic securitization make structured finance simpler, because the two are more complex forms of structured financial products. However, the legislator and

[136] ibid 29-30; Rapporteur: Wolf Klinz (n 92) 13-4.
[137] Deryn Darcy (n 124) 623.
[138] Section 1, People's Bank of China, Ministry of Finance, and China Banking Regulatory Commission, 'Notice of the People's Bank of China, the China Banking Regulatory Commission and the Ministry of Finance on Relevant Matters Concerning Further Expanding the Pilot Securitization of Credit Assets [中国人民银行、中国银行业监督管理委员会、财政部关于进一步扩大信贷资产证券化试点有关事项的通知]' (2012) No. 127 [2012] of the People's Bank of China (银发[2012]127 号）.
[139] Borong Liu [刘柏荣] and others (n 37) 86.
[140] ibid.

regulator may not be capable of putting or willing to put these limits on structured finance, not only because structured finance provides huge amounts of wealth to the national or reginal economy, but also because these regulatory limits will be strongly resisted by the market. For the economic concern, this reform proposal could be regarded as a periodical regulation, and it is flexible to the various regulatory demands. The current regulatory focus is the financial stability. Thus, this proposal seems to fit the present regulatory demand. When need to stimulate the economy, this proposal can be revoked. For the concern regarding the market resistance, the perquisite of this reform is a strong legislator and regulator. It explains why this proposal is not the EU and US' s preference but China's. As it will be discussed in the Chapter 5, enhancing regulation is necessary to deal with the CRA issue. In short, to better avoid conflicts of interest, prohibition on the issuance of structured finance is a solution.

Chapter 5: Oligopoly in the Credit Rating Industry

5.1 Introduction

Chapters 4, 5 and 6 are analyses of how the rating quality could be improved from three different perspectives. Chapter 4 focuses on conflicts of interest, while Chapter 6 focuses on the civil liability for CRAs. Oligopoly, is a big concern for all involved in a regulatory solution related to rating quality, is analysed in Chapter 5. To better address this concern, the following questions should be answered first: How should credit rating oligopoly status be addressed, especially in three areas? What are the differences in oligopolies in the European Union, United States and China respectively? How do oligopolies affect the credit rating industry? What are the existing regulatory approaches to deal with these negative influences? Are the regulations in place effective? If so, how; if not, why and is there any possible alternative to improve on them?

Before addressing the oligopolies in the United States, European Union and China, it is worth noting the following economic concepts, namely Herfindahl-Hirschman Index (hereafter 'HHI') and HHI inverse, which will be applied to determine the specific oligopolistic market structure in each area. The HHI and inverse of the HHI (hereafter 'HHI inverse') are often employed for discussing market structure as they are recognised techniques in the analysis of market structure for competition law and policy. Later, the negative influences associated with oligopolistic market are analysed. This chapter also discusses the impact of oligopoly on the reputation mechanism. In addition, the rent seeking theory aims to address the role of oligopoly in the relevant regulatory approaches. Next, to cope with these negative effects of oligopolies, the common regulatory strategy is to create incentives for incumbent rating agencies to improve rating quality through enhancing market competition. The regulations related to enhanced competition in the European Union, United States and China are discussed. Having illustrated the existing regulations, a possible regulatory reform to improve the rating quality is offered.

5.2 Oligopoly in the European Union, United States and China

5.2.1 How to Determine Oligopoly in the United States, European Union and China

An *oligopoly* (a Greek word meaning 'few sellers') can be defined as a market structure in which a few firms dominate.[1] In other words, where most shares of a market are owned by a few firms, this high concentration of market is an oligopoly.[2] It is worth noting before explaining the influence of oligopoly in the history of credit rating, to determine how CRAs are highly concentrated.

The current global credit rating market is an oligopoly dominated by a few CRAs, namely the big three[3]. The recognition of the oligopolistic nature of the rating industry is critical to assess the consequently negative influence in approaching the possible regulation. Lawmakers and researchers have recognised the oligopolistic nature of the credit rating industry.[4] There are approximately 150 local and international CRAs, while the big three occupy approximately 98 global per cent of the credit rating market share.[5] Table 5.1 provides the data with regard to the EU market shares of the big three from 2012 to 2018. Specifically, in 2018, the big three consisted of 93.4 per cent of the EU market share, and S&P and Moody's had 78.3 per cent market share (S&P consisted of 46.26 per cent shares while Moody's occupied 32.04 per cent).[6] Furthermore, in 2018, the big three occupied roughly 95 per cent of the US market share.[7] Moody's and S&P separately have 33.1 or 49.2 per cent market shares. Therefore, this can be regarded as oligopoly, even duopoly.[8]

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[1] Hal R. Varian, *Intermediate Microeconomics: A Modern Approach* (8th, International student edn, WW Norton 2010) 497.

[2] ibid.

[3] The *big three means* Standard & Poor's (hereafter 'S&P'), Moody's Investment Service (hereafter 'Moody's'), and the Fitch Group (hereafter 'Fitch').

[4] Lawrence J. White, 'Markets: The Credit Rating Agencies' (2010) 24 The Journal of Economic Perspectives 211, 216.

[5] ibid.

[6] ESMA, 'Report on CRA Market Share Calculation' (2018) 6 <https://www.esma.europa.eu/sites/default/files/library/cra_market_share_calculation_2018.pdf> accessed 21 March 2019.

[7] SEC, '2018 Annual Report on Nationally Recognized Statistical Rating Organizations' (2018) 15 <https://www.sec.gov/files/2018-annual-report-on-nrsros.pdf> accessed 8 November 2019.

[8] ibid 15.

Table 5.1 The EU Market Shares of the Big Three CRAs from 2012 to 2018[9]

CRA	2012 (%)	2013 (%)	2014 (%)	2015 (%)	2016 (%)	2017 (%)	2018 (%)
Moody's	39.18	37.51	36.50	34.67	31.29	31.27	32.04
Fitch	20.37	18.44	19.47	16.80	16.56	15.65	16.62
S&P	36.80	39.58	40.17	40.42	45.00	46.26	42.09
Total	96.35	95.53	96.14	91.89	92.85	93.18	90.75

More specifically, economists generally measure the extent of industry concentration by using the HHI[10] and the HHI inverse[11], because market shares may not fully reflect the extent of market concentration and competence.[12] As it seen in Table 5.2, the number of HHI below 1 500 means an unconcentrated market; the number of HHI between 1 500 and 2 500 means a moderately concentrated market; the number of HHI above 2 500 means a highly concentrated market. In short, the higher the figure, the greater the concentration. By contrast, a market with an HHI inverse of below 4 can be deemed highly concentrated; a market with an HHI inverse from 4 to 6.67 can be deemed moderately concentrated; and a market with an HHI inverse above 6.67 is considered to be unconcentrated. For example, in the US market, SEC reports indicate that an HHI for all NRSRO ratings outstanding is 3 472[13], as well as the HHI inverse number for the credit rating industry is 2.70[14]. Referring to the Table 5.3 the US credit rating market has an oligopolistic structure.

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9 Data collected from the ESMA annual report of CRA Market Shares Calculation (from 2012 to 2018)

10 'HHI, is generally used to measure market concentration, which is a measure of the size of firms in relation to the industry and an indicator of the amount of competition among them.' SEC, '2011 Annual Report on Nationally Recognized Statistical Rating Organizations' (2011) 8 <https://www.sec.gov/files/nrsroannrep0111.pdf> accessed 8 November 2019.; the figure of HHI ranges between 0 and 10 000 points, which indicates the various extents of industry concentration. See U.S. Department of Justice and the Federal Trade Commission, 'Horizontal Merger Guidelines' (2015) Section 1.5 <https://www.justice.gov/atr/horizontal-merger-guidelines-0> accessed 8 November 2019.

11 'HHI inverse, also can be used to represent the number of "effective competitors", or the number of firms with equal market shares that would produce an equivalent HHI score.' Toby Roberts, 'When Bigger Is Better: A Critique of the Herfindahl-Hirschman Index's Use to Evaluate Mergers in Network Industries' (2014) 34(2) Pace Law Review 908 <https://digitalcommons.pace.edu/cgi/viewcontent.cgi?article=1863&context=plr> accessed 10 November 2019.

12 U. S. Department of Justice and the Federal Trade Commission (n 10).

13 SEC, '2012 Annual Report on Nationally Recognized Statistical Rating Organizations' (2012) 12 <https://www.sec.gov/files/nrsroannrep1212.pdf> accessed 10 November 2019.

14 SEC, '2018 Annual Report on Nationally Recognized Statistical Rating Organizations' (n 7) 12-3.

Table 5.2 Two Ways to Measure the Extent of Market Concentration Through HHI and HHI Inverse

	HHI[15]	**HHI Inverse**[16]
Highly concentrated market	Above 2 500	Less than 4.0
Moderately concentrated market	Between 1 500 and 2 500	Between 4.0 and 6.67
Unconcentrated market	Less than 1 500	Above 6.67

Table 5.3 the US HHI Inverse of Credit Rating

Year	**HHI inverse of all rating**	**HHI inverse of all rating (excluding government securities)**
2008	2.99	3.56
2009	2.86	3.58
2010	2.88	3.55
2011	2.74	3.7
2012	2.75	3.68
2013	2.72	3.65
2014	2.68	3.81
2015	2.65	3.67
2016	2.67	3.78
2017	2.70	3.94

Things seem different in the Chinese credit rating market. The Chinese rating market is mainly held by China's rating agencies. First, the foreign CRAs were not allowed to enter in the Chinese credit rating market until the enactment of the 2017 PBOC announcement[17] that provides the detailed entry eligibility criteria for foreign CRAs. Consequently, the big three have provided rating services in China for long time by virtue of holding domestic CRAs. The big three hold 80 per cent shares of China's rating market.[18] For example, Moody's has

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[15] Data collected from The United States Department of Justice, 'Herfindahl–Hirschman Index' (2018) <https://www.justice.gov/atr/herfindahl-hirschman-index> accessed 20 August 2019.

[16] Data collected from SEC, '2018 Annual Report on Nationally Recognized Statistical Rating Organizations' (n 7) 12.

[17] *Announcement on Issues Concerning Providing Credit Rating Services by the Credit Rating Agencies on the Interbank Bond Market Announcement* [信用评级在银行间债券市场开展信用评级业务有关事宜公告] (Announcement No. 7 [2017] of the People's Bank of China [中国人民银行 公告[2017]第 7 号]).

[18] Yunzhi Lu, 'The Development of China's Credit Rating [论我国信用评级发展]' [2012] Modern Business Trade Industry, 27-8.

held 49 per cent shares of the CCXI[19] and took over the management right. Another example is that Fitch has held 49 per cent shares of Lianhe[20] and took over the management right as well. In January 2019, S&P, as the first foreign rating agency, was authorised by the National Association of Financial Market Institutional Investors (hereafter 'NAFMII') to enter the market, which means that S&P received approval to issue credit rating in the inter-bank market.[21] Next, one CRA should get the approval of at least one relevant regulator and can then enter in Chinese rating market. As is shown in the Table 5.2, up to December 2018, there have been 9 CRAs in the Chinese rating market. Furthermore, the incumbent large rating agencies received at least one approval from various regulators. Certification from various regulators means approval for various platforms. For instance, the Chinese Securities Regulatory Commission (hereafter 'CSRC') supervises and regulates the Security Exchange and the Securities Association of China (hereafter 'SAC') assists in self-regulation and management of CRAs registered on the Security Exchange. Therefore, one rating agency should first register on SAC and obtain approval from SAC, before issuing credit ratings on the Securities Exchange platform. In short, even though the big three hold Chinese rating markets shares, the level of the big three oligopoly is less severe than in the European Union and United States. As addressed in the Chapter 2, the multi-regulators system further separates market concentration because various regulators offered approvals to various CRAs in different bond issuing platforms.

[19] China Cheng Xin International Credit Rating Co. Ltd [中诚信国际], 'Introduction of Company' <http://www.ccxi.com.cn/247/Company.html> accessed 20 August 2017.

[20] China Lianhe Credit Rating Co. Ltd, [联合资信评估有限公司], 'Introduction of Shareholders' (2015) <http://www.lhratings.com/about/gudong.html> accessed 20 August 2017.

[21] Lianting Tu, 'S&P Global Gets Approval for China Local Rating Business' *People's Bank of China* (Bloomberg, 2019) <https://www.bloomberg.com/news/articles/2019-01-28/s-p-global-gets-regulator-nod-for-china-local-rating-business> accessed 6 August 2019.

Table 5.4 China's CRAs Approved by Various Regulators

CRA	NDRC[22]	CSRC[23]	PBOC[24]	CIRC[25]
Dagong[26]	√	√	√	√
Golden[27]	√	√	√	√
CCXI[28]	√		√	√
SB&IS[29]	√	√	√	√
Lianhe[30]	√		√	√
Fareast[31]		√		
Pengyuan[32]	√	√		
CCXR[33]		√		√
United Ratings[34]		√		√
China Bond Rating[35]			√	√

Before S&P obtained approval, there had been no foreign CRA that had been given approval to enter in the Chinese rating market. As a consequence, China's domestic rating agencies, rather than the big three, owned market shares of credit ratings. According to Figure 5.1, six of all the nine rating agencies own most of the market share. Between 2008 and 2014, Dagong, United Ratings and CCXI held roughly 85 per cent of the market share. By contrast,

22 National Development and Reform Commission, [国家发展和改革委员会].

23 China Securities Regulatory Commission, [中国证券监督管理委员会].

24 People's Bank of China, [中国人民银行].

25 China Insurance Regulatory Commission, [中国银行保险监督管理委员会].

26 Dagong Global Credit Rating Co., Ltd (hereafter 'Dagong'), Dagong Credit[大公国际资信评估有限公司] <http://en.dagongcredit.com/index.php?m=content&c=index&a=lists&catid=11> accessed 6 July 2019.

27 Golden Credit Rating International Co., Ltd (hereafter 'Golden'), Golden [东方金诚国际信用评估有限公司] <http://www.dfratings.com/news/info/15> accessed 27 July 2019.

28 China Chengxin International Credit Rating Co. Ltd (hereafter 'CCXI'), China ChengXin International Credit Rating Co., Ltd (CCXI) [中诚信国际信用评级有限公司] <http://www.ccxap.com/About.aspx> accessed 6 July 2019.

29 Shanghai Brilliance Credit Rating & Investors Service Co. Ltd (hereafter 'SB&IS') , Shanghai Brilliance Credit Rating& Investors Services(SB&IS) [上海新世纪资信评估投资服务有限公司] <http://www.shxsj.com/en/inside.php?menuid=106&catid=116> accessed 6 July 2019.

30 China Lianhe Credit Rating Co. Ltd (hereafter 'Lianhe'), Lianhe [联合资信评级有限公司] <http://www.lhratings.com/about/jianjie.html> accessed 6 July 2019.

31 Fareast Credit Rating Co., Ltd (hereafter 'Far East'), Far East [远东资信评估有限公司 <http://www.sfecr.com/ydgk/index_13.aspx> accessed 6 July 2019.

32 Pengyuan Credit Rating Co., Ltd (hereafter 'Pengyuan'), Pengyuan Rating[鹏元资信评估有限公司] <http://www.pyrating.cn/zh-cn/about/zizhizili> accessed 6 July 2019.

33 China Chengxin Securities Rating Co., Ltd (hereafter 'CCXR'), China Chengxin Securities Rating (CCXR) [中诚信证券评估有限公司] <http://www.ccxr.com.cn/about.asp?link=4> accessed 6 July 2019.

34 United Credit Rating Co., Ltd (hereafter 'United Ratings'), United Ratings [联合信用评级有限公司] <http://www.lianhecreditrating.com.cn/News.aspx?m=20140627095017653668> accessed 6 July 2019.

35 China Bond Rating Co., Ltd.(hereafter 'China Bond Rating'), China Bond Rating[中债资信评估有限责任公司] <https://www.chinaratings.com.cn/AboutUs/Profile/Overview/> accessed 6 July 2019.

since 2014, the other CRAs have held more market shares; in other words, the market competition gradually improved.

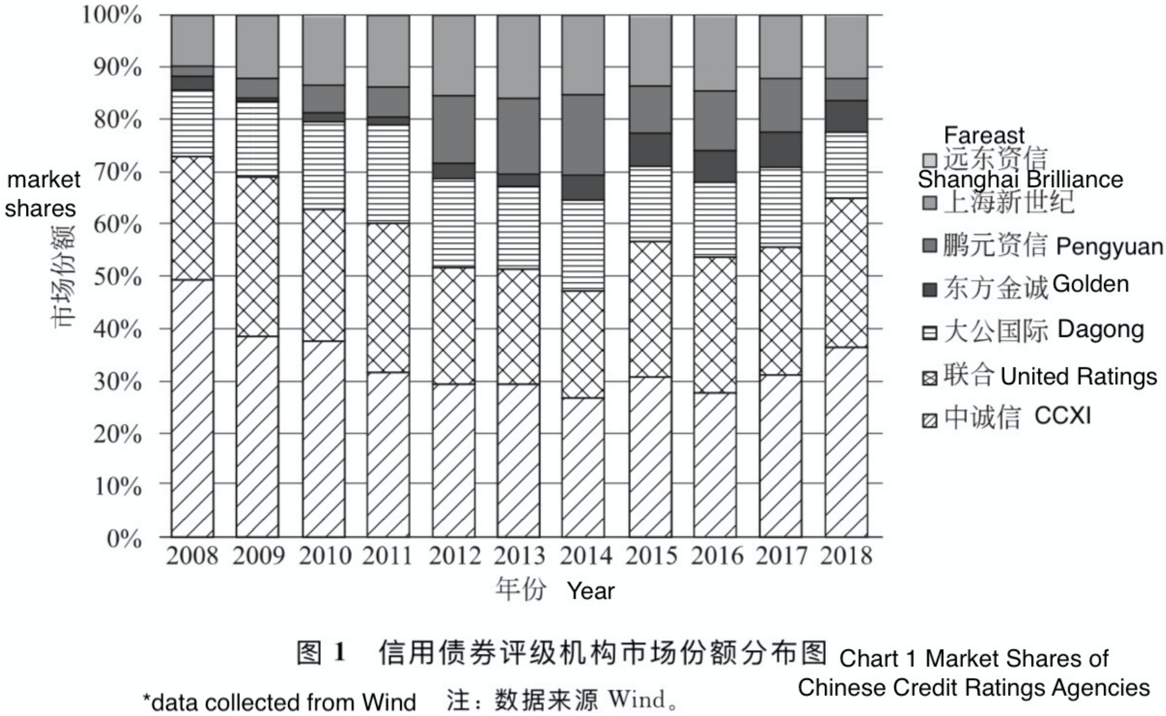

Figure 5.1 Market Shares of Chinese CRAs[36]

In addition, as can be seen from the Figure 5.2, the trend of HHI of China' credit rating has started to decrease since 2003. The recent HHI is around 2 000, and as related to Table 5.4, this figure means that the market concentration of China's credit rating falls in the moderately concentrated range. Compared to the United States and EU rating market, the Chinese rating market competition is higher.

[36] Hongyu Yao [姚红宇, 'The Reputation Mechanism of Credit Rating Agencies and Rating Upgrades— the Evidences from Chinese Credit Rating [评级机构声誉机制与评级上调 — 来自中国信用评级的证据]' (2019) 6(2) China Journal of Economics [经济学报] 128.

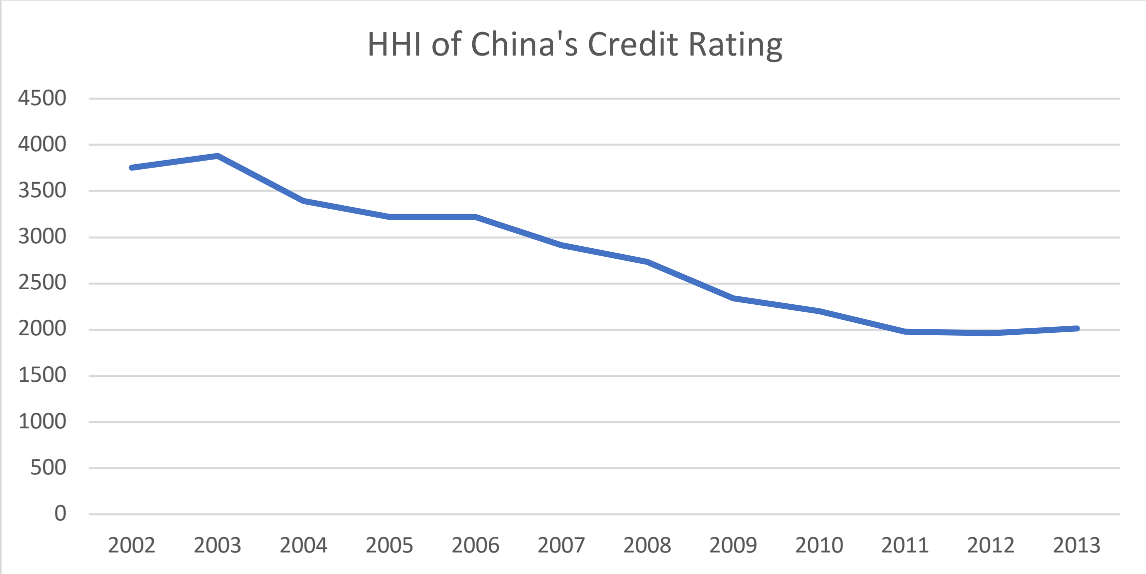

Figure 5.2 The HHI of China's Credit Rating[37]

5.2.2 Comparison of Oligopolies in Each Area

The oligopolies of the big three in the United States are attributed to the government certification NRSROs, as well as the expanding use of credit rating in regulation. For one thing, the government certification created a barrier to entry for CRAs. In 1975, the SEC created the concept of NRSROs and approved it for the largest CRAs, namely the big three.[38] As can be seen from Figure 5.3, only the big three were granted NRSRO authorization for many decades, and were thus conferred such a privileged status in the rating market. For another, the regulations over-reliance on NRSROs further underpinned the oligopolies of the big three. Early in the 1930s, credit rating was firstly used by regulators as a tool to distinguish investment grade from speculative grade securities.[39] Later in the 1970s, the SEC began to rely on CRAs as a regulatory tool. Subsequent to approvals of NRSROs, the SEC and other regulators linked numerous financial regulations to the credit ratings provided by one NRSRO,[40] which granted special market status to the NRSROs. As the substantive regulations relied on the NRSRO ratings, those ratings issued by NRSROs (namely the big

[37] Data collected from Mingming Li [李明明, 'Research on Functions, Defects and Market Structure of Credit Rating[信用评级业的功能，缺陷与市场机构研究]' (Doctoral Thesis, Shandong University 2016) 135.

[38] Andrew Fight, *The Ratings Game* (John Wiley & Sons Ltd 2001) 7.

[39] As mentioned in Chapter 2, the Office of the Comptroller of the Currency defined the term *investment securities* and required banks to exclusively invest in investment-grade bonds, which meant that bank holdings of publicly traded bonds had to be rated BBB or higher by at least one credit rating agency. See Lawrence J. White, 'Financial Regulation and the Current Crisis: A Guide for the Antitrust Community' 30 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1426188> accessed 28 September 2019.

[40] Emily McClintock Ekins and Mark A Calabria, 'Regulation, Market Structure, And the Role of the Credit Rating Agencies' (2012) No.704 Policy Analysis 9-10 <https://www.cato.org/sites/cato.org/files/pubs/pdf/PA704.pdf> accessed 29 September 2019.

three in that period) became more influential and valuable; in other words, the regulatory privilege further enhanced the barrier to entry for other small CRAs.

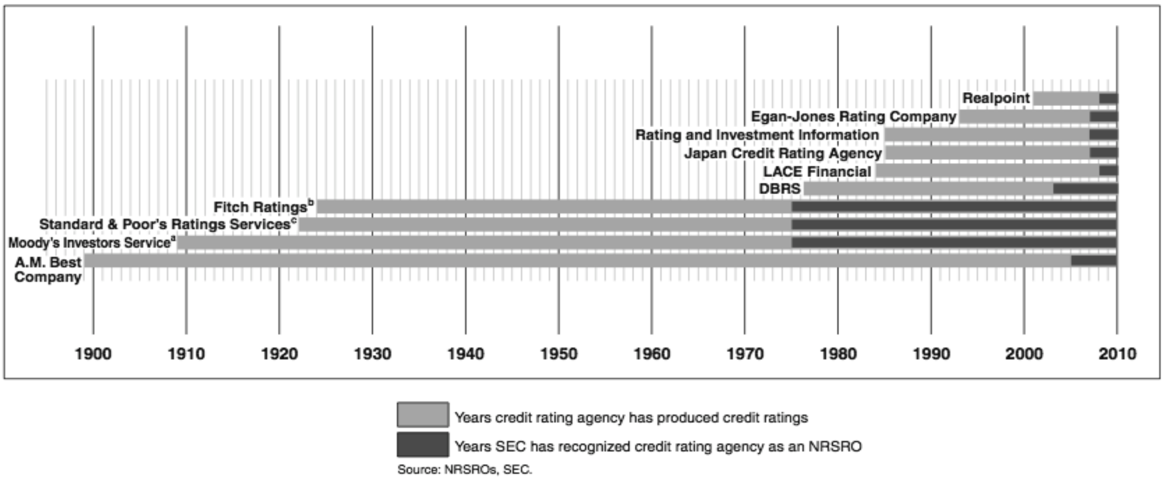

Figure 5.3 Credit Rating History of Current NRSROs from 1900 to 2010[41]

Apart from that, in the 1970s, the bond market entered an era of globalization. Bond markets expanded, ranging from the United States to the world, and CRAs reformed the business model to the investor-pays model. Consequently, the credit rating market further enlarged. During this period of market expansion and transition, the big three seized the opportunity to occupy most of the market share of the credit rating.

In the EU market, the reputation mechanism once became a barrier to entry for other small agencies. With the globalization and the interaction of the US financial market, the EU credit rating market was significantly affected by the US credit rating industry at the beginning. In this regard, the long-term reputation capital of the big three plays a vital role in the EU credit rating oligopoly. Leading up to the big three entering the EU market, they had accumulated abundant positive reputation capital. A positive reputation cannot be built by a CRA in one day because it takes time to verify the accuracy and quality of the rating services that the agency provides. Further, the credit rating industry has not been regulated for many decades, and thus the reputation mechanism was the only self-regulation tool in the rating market.

The dynamics of the credit rating industry is more complicated. Why do the three rating agencies occupy the bulk of the market? Besides the governmental certification and

[41] SEC, 'Action Needed to Improve Rating Agencies Registration Program and Performance-Related Disclosures', 57<http://www.gao.gov/new.items/d10782.pdf> accessed 28 Sep 2019

reputation capital, there must be another reason, otherwise, the oligopolistic market structures should have changed in the US market or the EU market after the SEC had designated more CRAs as NRSROs and more rating agencies were approved to enter into EU rating market by European Securities and Market Authority (hereafter 'ESMA.')[42]. However, most of the market shares are still owned by the big three. For these new CRAs, if they compete with the big three on price, issuers are still more likely to choose the big CRAs, because the savings that issuers enjoy from a rating service by new CRAs are more likely to be less than the financial and reputational costs that an issuer bears when the issuance is not accepted by the investors or market.[43] Put another way, the common way to lower price for a small rating agency is to cut the cost and this certainly may be at the cost of reducing rating quality, which is the key to market and investor confidence in credit rating. As a result, the final cost is still paid by the issuer. Therefore, competing on price cannot make inroads into the rating market. In contrast, competing on expertise does. For instance, when the big two (Moody's and S&P) each held roughly 40 per cent of market share, Fitch promptly made inroads into the rating market by its expertise in structured finance.[44] In short, another possible reason is expertise.

Besides the expertise, economic power is another big competitive advantage for incumbent CRAs.[45] Specifically, structured financial products or other novel securities, such as MBSs[46] and collateralized debt obligations (hereafter 'CDOs'), have high requirements for the rating staff and rating analysis. In general, the incumbent and large rating agencies are more likely to have better capability to collect and analyse the private information of rated entities and afford higher sunk cost in rating methodologies. The huge entry cost became another barrier to entry for other small CRAs. In other words, the big three, compared with other EU small rating agencies, have more advantages in market competition. Consequently, the oligopolistic market of the big three was again more intensive in the EU rating market.

In China, the oligopolies in the market structure are not so distinct, even though the market is still moderately concentrated. Like the United States, governmental certification also plays

[42] Since 2011, the EU CRAs should apply for registration or certification from ESMA. Regulation No. 513/2011 of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies (OJ 2011 L 145).
[43] Claire A. Hill, 'Limits of Dodd–Frank's Rating Agency Reform' [2011] Chapman Law Review 141.
[44] Alec Klein, 'Smoothing the Way for Debt Markets: Firms' Influence Has Grown Along With World's Reliance on Bonds' [2004] The Washington Post A18 <http://www.washingtonpost.com/wp-dyn/articles/A5573-2004Nov22.html> accessed 6 June 2018.
[45] Jack T. Jr. Gannon, 'Let's Help the Credit Rating Agencies Get It Right' [2012] 31 Rev. Banking & Fin. L. 1015, 1020.
[46] Mortgage backed securities

a significant role in the oligopolistic market structure. As mentioned above, government approval from one relevant regulator is the precondition to enter the rating market. Furthermore, even registration and the establishment of CRAs should be authorised by one relevant regulator.[47] These regulations can be deemed as the primary barrier to entry. During long periods, the big three did not obtain approval to enter the Chinese market for long periods until S&P was authorized in 2019.[48] Thus, China's rating market is divided by a handful of domestic rating agencies. According to Table 5.3 and Figure 5.1, the large rating agencies that own more market shares generally received more government licences from regulators. It is because one government licence means a gate pass to one securities platform. The more gate passes rating agencies have, the more rating markets they could enter into. For example, the approval from PBOC implies a gate pass to the inter-bank market, while the approval from the CSRC is the pass to the Securities Exchange market. In short, it is obvious that, like the United States, government approval has a huge influence on the current market shares of credit rating in China.

The oligopolies of both the EU market and the Chinese market are affected by the big three. Leading up to the financial crisis, the European Union did not set government authorisation for CRAs; in other words, the big three entered into the EU rating market without regulatory barriers. The big three occupied the EU rating market rapidly through their reputation capital, economic power and professional staff. By contrast, even though due to regulatory limits, the big three were not able to enter into China's rating market for long periods, they could still hold shares of domestic rating agencies. In addition，S&P received approval and entered China's rating market in 2019. This approval implies that China is willing to allow one of the big three to enter its rating market, which is also support for the fact that the market concentration by the big three is not serious compared to the other areas.

5.3 The Negative Influences Caused by Oligopoly

As addressed above, the current credit rating industry fits the classic mould of an oligopoly. The characteristics of oligopoly manifest in the barriers to entry, few market competitors and independency of oligopolies members. Oligopoly itself can be regarded as a common

[47] Article 169 of Securities Law of the People's Republic of China (2014 Amendment) [中华人民共和国证券法(2014 修正)] 2014 (Order No 14 of the President of the People's Republic of China).
[48] Lianting Tu (n 21).

market structure, but the negative consequences oligopoly is accused of make it a regulatory object.

5.3.1 The Characteristics of Oligopoly

a. Barrier to Entry

At first, the government certification is the most common barrier to entry. As discussed in the United States and China rating market, a CRA must get approval from the relevant regulator to be able to enter into the domestic rating market. For example, an NRSRO is a typical government certification. This kind of barrier to entry, on the one hand, ensures the basic expertise of market participants in one particular industry and, on the other hand, it prevents new and small market participants from entering the particular market.

Second, a positive reputation is another barrier to entry in one industry, because a good reputation needs a long time to be built.[49] Markets and investors are inclined to choose market participants with a positive reputation, and the new market participants thus have to appeal to customer with more time capital or other efforts. In the EU rating market, the big three naturally and promptly acquired numerous market shares, depending on their positive reputation built up before. By contrast, new CRAs are faced with strong barriers to entry.

The final barriers are the expertise and economic power of incumbent agencies.[50] Especially in some industries with highly technical requirements, high-quality expertise will be a stranglehold that large market participants will have on this industry for entry. For the rating industry, the technical barrier manifests in the novel structured finance, such as RMBSs[51] and CDOs. Additionally, the strong economic power is a big advantage for incumbent rating agencies. Compared with small rating agencies, the large rating agencies are more capable of affording the sunk cost, as well as development cost.

b. Few Market Competitors

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[49] John Patrick Hunt, 'Credit Rating Agencies and the Worldwide Credit Crisis: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement' (2009) 2009(1) Columbia Business Law Review 109.
[50] Jack T. Jr. Gannon (n 45) 1020.
[51] Residential mortgage backed securities

As a consequence of barriers to entry, we also observe another characteristic in oligopolistic market, namely few market participants. Specifically, the number of capable market competitors among those market participants for oligopolies members are much fewer. Furthermore, actions by the oligopoly members will affect one another.

5.3.2 The Negative Consequences of Oligopoly in the Credit Rating Industry

Why does an oligopolistic rating market need to be changed? The main risk of the oligopolistic rating market structure is the rating quality decline, which mainly manifests in two aspects: (i) rating inflation and (ii) inaccurate rating methodologies. Once oligopolistic CRAs are aware of their dominant market positions, they are less likely to fear other market competitors, and they thus lack incentives to improve their rating quality. In theory, an oligopoly market is inclined to decreased productivity.[52] In the credit rating industry, the decreased productivity manifests in the forms of inflated rating and methodology flaws.[53] During the global financial crisis of 2007–8, the big three were criticized for overrating structured financial products with inaccurate rating methodologies.[54]

For one thing, oligopolistic members do not fear the losses of market shares to other new competitors and, at the same time, oligopolistic market structure intensifies the limited competition among incumbent oligopolistic members. The big three who have privileged market positions and lack threats from other competitors are less than the cutting-edge level of their capabilities. Among the whole market, oligopolistic members do not need to compete on rating quality, because they are able to easily maintain the market share. Once CRAs do not fear the losses of market share or removal by alternative CRAs, the deterrence under the reputation mechanism no longer works. This addressed the failure of reputation mechanism in the credit rating market, as will be further analysed in the following section. Within the group of oligopolistic members, they may compete by favouring their clients, even at the cost of reputation. The issuer-pays model[55] created incentives for CRAs and they are thus likely to use lax standards and provide overly optimistic ratings in favour of their clients, that is, issuers. For example, as the emails record, Gale Scott, a potential rating service client

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[52] Edwin Mansfield, *Microeconomics: Theory and Applications* (Norton 1970) 330; Economics Online, 'Oligopoly: Defining and Measuring Oligopoly' <https://www.economicsonline.co.uk/Business_economics/Oligopoly.html> accessed 24 September 2019.

[53] Jack T. Jr. Gannon (n 45).

[54] In some cases, the quality of synthetic CDO-squared securities was overstated by S&P, as Kai Gilkes, a former S&P quantitative analyst, argues. See *Claude A Reese, et al v the McGraw-Hill Companies Inc, et al* [2008] United States District Court, Southern District of New York Civil Action No.1:08-cv-07202-PKC,44.

[55] The business models of all the big three are the issuer-pays model.

as well as issuer, threated to lose business against S&P unless S&P relaxed its rating methodologies.[56] Then Gugliada, the S&P top CDO-rating executive, replied with ‘OK with me to revise criteria’.[57] Kai Gilkes, a former S&P quantitative analyst, discovered a flaw in the main CDO model of S&P.[58] As Gilkes believes, because of the competitive considerations, S&P system overstated the many synthetic CDO-squared securities.[59] Therefore, negative competition, or even malignant competition may arise. This risk stemmed from the conflicts of interest under the issuer-pays model.

For another, oligopoly members lack incentives to continually improve their rating quality and accuracy, especially when they aware of them dominate market status.[60] This demotivation for rating agencies explains the failure of reputation theory in the credit rating industry from another aspect. The risk of oligopoly is to suppress innovation in rating techniques and methodologies.[61] In an ideal market, rating agencies utilise various rating methodologies and they compete with one another depending on their rating quality by continually updating their rating models and methodologies. As a result, the rating agency with the best rating methodology survives. Nevertheless, in reality, the big three utilise similar rating methodologies. As mentioned in Chapter 4, rating the structured financial products offers huge amounts of short-term profits for CRAs, and CRAs are incapable of accurately providing credit ratings associated with structured finance. When the most rating agencies pay attention to the short-term interest instead of long-term reputation, the cost of good behaviour may be higher. The worse thing is that oligopoly may not only deter other new CRAs entrants with updated rating methodologies from entering the rating market, but also demotivate incumbent CRAs from improving their rating quality. These negative consequences of oligopoly, and the interaction between oligopoly and conflicts of interest have a joint influence on the credit rating market. A vicious circle may eventually be formed in the rating industry.

Apart from that, an oligopolistic market structure may also increase regulatory costs and impediments, even when dealing with other issues, such as conflicts of interests, in the rating industry. In the absence of motivation in an oligopolistic market, Justensen states that it would be very hard to design a regulatory regime to motivate rating agencies to provide

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[56] *Claude A Reese, et al v. the McGraw-Hill Companies Inc., et al* (n 54) 43.
[57] ibid.
[58] ibid 44.
[59] ibid.
[60] Jack T. Jr. Gannon (n 45) 1025.
[61] ibid.

responsively leading likely prospects in terms of novel investment products.[62] In general, an oligopolistic market is more likely to decrease alternative options of rating agencies and increase costs paid by rating users. These costs will finally transfer to investors and even the whole market.[63]

More importantly, at the EU level, besides the negative consequences cited above, the European Union has a political motivation for breaking up the oligopoly of global CRAs. The big three[64] risk threatening regional financial stability. Following the financial crisis of 2007–8, many commentators criticized them for causing sudden sovereign downgrades, precipitating or exacerbating the euro area crisis.[65] For example, Mr Jurgen Klute MEP argued that the CRAs created false panic and encouraged speculation by implausible sovereign downgrades in the southern European Union. Furthermore, Dr Wolf Klinz MEP stated that CRAs held a specific rating for longer than really justified and suddenly issued the downgrade at a specific time, particularly a few days before decisive meetings, which exacerbated the situation.[66] Even though, according to the current investigation and analysis by the European Union Committee, it cannot be determined whether these sovereign downgrades precipitated or exacerbated the euro area crisis,[67] many EU leaders supported greater competition in the credit rating industry. For example, as the German Finance Minister argued, breaking the oligopoly of the big three was needed and it was thus necessary to increase competition.[68]

5.3.3 The Failure of Reputation Mechanism in Credit Rating Industry

As discussed in Chapter 4, the conflicts of interest and oligopoly interreacted with each other, and the complexity and profitability of structured finance are the main causes for the failure of the reputation mechanism.

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[62] Paul J. Justensen, ‘Ratings Recall: Will New Reform Proposals Make Lasting Impact?’ (2009) 35 Journal of Corporation Law 193.
[63] Linying Ma [马林影], ‘Behaviour Analysis of the U.S. Credit Rating Agencies in the Financail Crisis and the Study on Their Regulatory Reform [金融危机中美国信用评级机构行为分析及监管研究改革]’ (Doctoral Thesis, University of Jilin 2014) 103.
[64] The Moody’s and S&P are US CRAs. while Fitch is now majority-owned by a French CRA. See House of Lords European Union Committee, ‘European Union Committee 21st Report. Sovereign Credit Ratings: Shooting the Messenger?’ (Authority of the House of Lords 2011) HL Paper 189, 24.
[65] See Europarl interview with Jurgen Klute MEP, Rein in the rating agencies, says Jurgen Klute, 7 June 2010 ibid 17.
[66] ibid 19.
[67] ibid 26.
[68] BBC News, ‘Rating Agencies Criticised by European Commission’ (July 2011) <https://www.bbc.com/news/business-14043293> accessed 10 February 2020.

In terms of poor rating quality, oligopoly provides essential market perquisites. In addition, the failure of the reputation hypothesis explained the causality between regulations regarding enhancing market competition and oligopolistic market structure. This chapter will address this.

Under the reputation mechanism, the credit rating industry had not been regulated for many decades. In essence, the reputation mechanism could be regarded as an integral part of private ordering.[69] The credit rating industry remains self-regulated. Entering the twenty-first century, the Enron and other relevant scandals have raised the question whether or not regulation is needed for the credit rating market. [70] As a response, the Credit Rating Agency Reform Act of 2006 was enacted later.

According to the reputation mechanism, if CRAs issue inaccurate ratings, their reputation that they have built up over many years would be damaged and their business would also suffer. In theory, market participants self-discipline themselves and behave well under the reputation mechanism when they fear the long-term and huge losses caused by bad reputation. For the credit rating industry, a rating agency is more likely not to risk its reputation by issuing low-quality ratings, because the core competency of rating industry is its reputation through high-quality, accurate ratings. This is reputation capital theory.[71] Prior to the financial crisis, reputation theory was regarded as the dominant view that CRAs could be driven by their reputation to maintain their integrity because their profitability was directly associated with reputational capital.[72] However, during the recent financial crisis, even though the CRAs issued large amounts of inflated rating of structured financial product,

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[69] Barak D. Richman, 'Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering' (2004) 104(8) Columbia Law Review 2328, 2367

[70] In 2001, the rating of Enron's debt was not downgraded to 'speculative grade' until four days before Enron announced insolvency. Before its downgrade, Enron's debt kept 'investment grade' for a long time, but it should earlier have been rated as 'speculative' status. See Claire A Hill, 'Rating Agencies Behaving Badly: The Case of Enron' (2003) 35 Conecticut Law Review 1145; other relevant scandals include WorldCom which was rated 'investment' status three months before filing for insolvency; Global Crossing was rated 'investment' status in March 2002 and defaulted on loans in July 2002 and so on. See SEC, 'Egan-Jones Ratings Company' (10 November 2002) <https://www.sec.gov/news/extra/credrate/eganjones2.htm> accessed 29 September 2019. The Enron Scandal raised the alarm that self-discipline regulation in the credit rating industry was far from enough.

[71] John Patrick Hunt (n 49).

[72] Mohammed Hemraj, Credit Rating Agencies: Self-Regulation, Statutory Regulation and Case Law Regulation in the United States and European Union (Springer 2015)

the CRAs did not lose business due to the decline in quality. This is considered as the failure of the reputation mechanism.

As analysed in Chapter 4, the complexity and short-term profitability of structured finance are the obstacles against the reputation mechanism. Oligopoly further exacerbates the failure of reputation mechanism. First, once the big three are aware of their dominant market status of the rating market, this oligopolistic market structure, to some extent, takes away the fear of reputation loss under the reputation mechanism. Specifically, in an oligopolistic market, due to the strong barriers to entry, the big three receive abundant payoff at the cost of little reputation capital. Apart from that, the 'herding' behaviour[73] in the oligopolistic market further reduces the final costs of the big three. If all the oligopolistic members choose to make the mistake in a conformable manner, they are more likely to bear low cost because there is no other competitive alternative in the market. Therefore, these oligopolies members pay less attention to their long-term reputation and do not worry about their loss of market share.

Second, the reputation mechanism has a limited effect on structured finance, because positive reputation needs long periods to be built up, while the rating agencies have not accumulated sufficient reputation in the novel structured financial products.[74] Put another way, especially when the big three are secure in the knowledge of their dominant market status as well as the limited rating methodology in structured finance throughout the whole rating industry, they tend to issue large quantities to ratings of structured financial products with no fear of reputation capital.

From a regulatory perspective, in order to create incentives that motivate rating agencies, they persistently update their rating methodology. Enhancing market competition can provide alternative deterrence for incumbent rating agencies. In short, the oligopolistic market provides an explanation for the failure of the reputation theory. The essence of failure of the reputation mechanism in the credit rating industry is that in the oligopolistic market, the motivation and deterrence under the reputation mechanism are no longer effective. For one thing, in an oligopolistic market, oligopoly members lack the incentives to behave well, such as updating advanced techniques and corporate governance codes so as to keep their good reputation, because the payoff of keeping a good reputation remains low in this

[73] Herding behaviour here means 'the ratings of one agency track those of another'. See Jack T. Jr. Gannon (n 45) 1028.
[74] ibid.

situation. For another, the reputational cost becomes less for the oligopoly members and the deterrence if reputation loss is thus weak. As a result, the chance of misbehaviour by oligopoly members is high in that they do not fear the economic and reputation costs accused with their bad behaviour; in other words, what accounts for the losing fear of market share or replacement for credit ratings agencies? Because of the failure of the reputation theory, oligopolistic market status for the large CRAs removes their fear of removal or replacement of other new CRAs. Therefore, it is incumbent for regulators and the market to create another deterrence.

5.3.4 Rent Seeking Theory and Public Good Theory

Robert Tollison defined *economic rent* here as the excess return of the resources owner's opportunity cost.[75] Put differently, *Economic rent = revenue – opportunity cost.* Rent seeking can be regarded as an attempt for rent. In some economic definition, rent can equal profit, and thus rent seeking activity can also be regarded as profit seeking activity. The most distinct difference between rent seeking and profit seeking activities is that rent seeking itself is non-productive and it does not create social wealth.

Anne Krueger defined *rent seeking* as 'the activity of pursuing the higher wages available in the monopolized sectors',[76] in other words, she regarded it as a waste of social resources relying on a special monopoly or oligopoly market status. Therefore, the monopoly is the precondition why market participants can gain more revenue through rent that is even non-productive. The rent seeker often takes advantage of the policy privilege or the market status of monopoly or oligopoly in pursuit of more revenue. However, this makes poor allocation of social resources and decrease social incomes as a whole.

To discuss the monopoly status, the public good theory should be applied here. According to the public good theory, pure public good normally cannot be provided by the private sector because the profit is insufficient. Also, owing to the huge cost, government cannot offer such public good either. Apart from that, the free-rider problem often occurs associated with public good, which need to be overcome with government innervation. Government often ensures market status of some sort in the private sector through the issuance of licences.[77]

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[75] Robert D Tollison, 'Rent Seeking: A Survey' (1982) 35(4) Kyklos 575.

[76] Roger D. Congleton, 'The Nature of Rent Seeking' in Roger D. Congleton and Arye L. Hillman (ed), *Companion to the Political Economy of Rent Seeking* (Edward Elgar Pub Ltd 2015), 3.

[77] Geoff Riley, 'Public Goods and Market Failure' <https://www.tutor2u.net/economics/reference/public-goods> accessed 10 April 2018.

Some scholars regard credit rating as a kind of public good because it reduces the information asymmetry between investors and the financial market, even though the rating is paid for by the issuer.[78] In the late 1960s, with the introduction of photocopying technology, under the investor-pays model, CRAs were able to generate enough profits and then shifted to the issuer-pays model. Later in the 1970s, the SEC created NRSRO as regulator licences and offered the licences to the three big CRAs. However, this good-faith government intervention tends to become the political or regulatory privileges for rent seekers.

As Cash states,[79] revenue through the provision of ancillary services is rent. The investment in ancillary services rather than other businesses is rent seeking behaviour for a CRA and its affiliate. The return of investment in the other normal industry (i.e., non-oligopolistic industry) is opportunity cost. The oligopoly market of credit rating has been gradually formed since the SEC offered NRSRO, namely regulatory licence, to the big three. The big three take advantage of the oligopolistic status to sell ancillary services, some of which is something that CRA already did and just packaged it to be re-sold.

There are three points that could be summarised: as follows first, as discussed in Chapter 3, regulatory licences enhance the oligopolistic market structure, and the over-reliance on credit ratings should continue to be decreased. Second, as introduced in Chapter 4, the ancillary service and rating services related to structured finance provides numerous rents for CRAs. Therefore, the ancillary services need to be separated from the rating service, while the complex securitization with regard to structured finance should be forbidden. Third, once the oligopolistic market formed, market self-regulation seems less effective to cope with the relevant problems. Financial regulation and government interference thus need to be enhanced.

5.4 The Existing Regulatory Approaches to Cope with Oligopoly

The main regulatory purpose is to boost rating accuracy. It may be very hard to design a regulatory regime to motivate rating agencies to actively revise their rating methodologies and optimize rating models regularly. Some scholars argue that the quality of ratings would

[78] Jin-Chuan Duan and Elisabeth Van Laere, 'A Public Good Approach to Credit Ratings – from Concept to Reality' (2012) 36 Journal of Banking & Finance 3239.
[79] Daniel Cash, 'The Issue of Ancillary Service Provision', *Regulation and the Credit Rating Agencies: Restraining Ancillary Services* (Routledge 2019) 140–3.

improve if the market competition increased.[80] Referring to analysis in the failure of reputation theory, creating new deterrence for the big three to innovate and improve rating quality is the solution. In this regard, the common regulatory strategies are to enhance market competition. More specifically, this mainly includes two methods: the first one is to lower barriers to entry and the second one is to weaken the regulatory privileges.

In the United States, the first regulatory approach is to decrease barriers to entry, or in other words, reduce the regulatory privileges of the big three, through approving more NRSROs after Credit Rating Agency Reform Act of 2006 (hereafter 'CRARA').[81] The financial crisis of 2007–8 to some extent proves the inefficacy of this regulatory approach of increasing market competitors through approving more governmental certification. Apart from that, later in 2010, another kind of regulatory approach under the Dodd–Frank Act attempted to increase market competition through weakening the regulatory privileges of the big three.[82] Given that the approval of NRSROs offering a special market status to a limited group of CRAs, section 939A of the Dodd–Frank Act requires all the US regulators to review each rating-based rule in their regulations and remove those rating-based rules that induced uncritical reliance on external credit ratings, as well as substitute them with the alternative standards.[83] This implies that the Dodd–Frank Act not only requires ending the hardwiring of credit ratings in the US legislation between US regulators and credit ratings, but also attempts to change the dominant role of NRSROs in the rating market. Secondly, in order to encourage small CRAs, the Dodd–Frank Act has some provisions in favour of small CRAs. For example, section 932 of the Dodd–Frank Act entitles the SEC to exempt small NRSROs from public disclosure duty when the duty is considered unreasonably onerous.[84] Additionally, given the difference in capability to acquire information between small CRAs and the big three, improving information transparency and reducing this difference may foster competition in the credit rating market. Specifically, Rule 17-5 requires issuer to

[80] Hill states that what is necessary in the long term in the current credit rating industry is vigorous competition. See Claire A. Hill (n 43).

[81] Prior to CRARA, the NRSRO concept lacked detailed definition or a guidebook. As a consequence, it was hard for other CRAs to apply for an NRSRO regulatory licence. This set a higher barrier to entry in the US rating market. See Emily McClintock Ekins and Mark A Calabria, 'Regulation, Market Structure, And the Role of the Credit Rating Agencies' (2012) No.704 Policy Analysis, 11 <https://www.cato.org/sites/cato.org/files/pubs/pdf/PA704.pdf> accessed 29 September 2019.

To cope with the vague definition of *NRSRO*, section 3 of CRARA determines the NRSRO concept, and requires the SEC to set clear standards and categories regarding the application and approval of NRSRO. In addition, section 4 of CRARA also specifies the detailed process and requirements of registration application for the SEC. Credit Rating Agency Reform Act of 2006 (Pub L No 109–291, 120 Stat 1327).

[82] ibid 31.

[83] SEC, 'Report on Review of Reliance on Credit Ratings' (2011) 1 <https://www.sec.gov/files/939astudy.pdf> accessed 20 April 2020.

[84] Section 932 of the Dodd-Frank Act 2010 (Public Law 111-203).

enable equal access to the obligation to rate regarding structured financial securities.[85] If an issuer provides a CRA with information with respect to a structured financial product, it should make the information fairly and fully available to other NRSROs so that these NRSROs are able to issue their own ratings.[86]

However, all the relevant regulations under the Dodd–Frank Act do not change the oligopolistic market structure nor provide an effective mechanism which therefore encourages small rating agencies to participate in the rating market. On the surface level, these regulations may seem like a lower barrier to entry, the regulations have less impact on the oligopolistic market due to the combined advantages of the big three which are too big to challenge, including expertise, financial and reputational capital.

According to the 2010–2012 Report of the European Union Committee, the EU leaders showed concern about the current oligopolistic rating market and suggested that greater competition was needed to improve the oligopoly.[87] In 2013, ESMA designed a rotation mechanism involved in the regulatory framework so as to enhance market competition in the credit rating industry. According to Article 6(b) of Regulation 2013, the maximum duration of a contractual relationship with the same CRA is four years. In addition, the maximum duration is excluded for small CRAs who have fewer than 50 employees or whose annual turnover from credit rating activities is less than EUR 50 million.[88] This regulation provides more business opportunities for small CRAs, and also prevents long-term and overfamiliar contractual relationships between issuers and the big three. In other words, it indicates the European Union's attempt to change the current oligopolistic market structure of the big three.

There are two main regulatory purposes of such regulation: first, the rotation mechanism created business opportunities for other small CRAs, thus improving market competition. Second, the regulation also aims to improve the oligopolistic market through weakening the regulatory privileges. Nevertheless, the efficiency of the rotation mechanism should be further examined. Even though, under the rotation mechanism, small rating agencies obtain

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[85] SEC, 'Order Extending Temporary Conditional Exemption for Nationally Recognized Statistical Rating Organizations from Requirements of Rule 17g-5 under the Securities Exchange Act of 1934 and Request for Comment' (2012) Release No. 34-68286; File No. S7-04-09.
[86] Robert J. Rhee, 'On Duopoly and Compensation Games in the Credit Rating Industry' (2013) 108 Nw U L Rev, 124.
[87] House of Lords European Union Committee (n 64).
[88] Point 4 of Article 6b of Regulation (EU) No. 462/2013 of the European Parliament and of the Council of 21 May 2013 Amending Regulation (EC) No. 1060/2009 on Credit Rating Agencies (OJ 2013 L 146).

more opportunities to participate in the market, especially in structured financial products, they lack sufficient expertise to make the professional rating report.[89] They still cannot improve their rating quality to a satisfactory level in the short time because of their limited expertise and finance. Therefore, the credit ratings provided by small rating agencies may not be accepted by the market and investors;[90] in other words, small CRAs may not obtain sufficient capability to compete with the big three in the short term. This implies that the rotation mechanism has a limited impact on motivating the big three to improve their rating quality on the fear that small CRAs gain the market share from the big three. In short, whether or not the rotation mechanism is able to achieve the regulatory objects remains to be seen in the future.

Given that the moderate market competition in the credit rating industry, the current regulations regarding oligopolies in China seem obviously different. On the one hand, the current regulation does not change higher barriers to entry for new CRAs. CRAs should get approval to engage in the securities market from the relevant regulator.[91] The requirements of application for registration are strict. For example, the registration capital is RMB 20 million.[92] Another example would be, if one rating agency applies for approval, it should have more than ten rating analysts, and each rating analyst should have at least three years' relevant working experience.[93] In practice, market or investors naturally gravitate towards those CRAs that have strong expertise and economic power. These regulations further intensify this trend. As a result, the oligopolies of incumbent rating agencies in China are more likely to remain. On the other hand, the practice that foreign CRAs are allowed to enter China's rating market indicates the regulatory purpose of enhancing market competition.

5.5 A Supplementary Proposal for the Existing Regulations

Many regulatory approaches attempted to improve market competition so as to reduce such negative effects under an oligopolistic market. However, most of the existing regulations

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[89] Konstantinos Sergakis, 'Chapter 13 Credit Rating Agencies', *The Law of Capital Markets in the EU: Disclosure and Enforcement* (Palgrave 2018) 284.
[90] ibid.
[91] Article 169 of Securities Law of the People's Republic of China (2014 Amendment) [中华人民共和国证券法(2014 修正)].
[92] Provision 7(1) of Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market[证券市场资信评级业务管理暂行办法] (No 50 [2007] of China Securities Regulatory Commission [证监发[2007] 50 号]).
RMB 20 million nearly equals GBP 2.2 million/USD 2.8 million.
[93] Provision 7 (2) of ibid.

have proven to be insufficient and ineffective. As discussed in section 5.2, the current EU and US credit rating markets are still highly concentrated, while the current China rating market is moderately concentrated; in other words, all these regulations have not changed the oligopoly of the big three. In the US rating market, more NRSRO approvals seldom change the oligopolistic market of the big three. In the EU market, the rotation mechanism has its flaws in many respects. In the Chinese market, it tries to enhance market competition through approving S&P's entering domestic market. One possible reason is that oligopoly makes the oligopolistic members stronger and more powerful than the regulators and thus regulators are unable to minimize the rent or add more regulatory requirements on CRAs. However, whether the regulatory attempt exerts any influence over the Chinese domestic market competition requires more time to verify.

These existing regulations brings up the question of whether greater market competition will or will not boost rating accuracy. Figure 5.4 compares amounts of bonds categorised by each rating level between high-competition and low-competition market. From 1995 to 2006, the distinct change in terms of rating market shares is that Fitch's made inroads into the rating market and became the final oligopolistic member in the rating industry. Thus, in Figure 5.4, we assumed when the market shares of Fitch's are more than the average market shares, the market is high-competition; otherwise, that is a low-competition market.[94] It takes Fitch's as an example to cast doubt on the common perception between market competition and rating accuracy.

[94] Linying Ma [马林影] (n 63).

Figure 5.4 Comparisons of Bonds Ratings Between a High-Competition and Low-Competition Market [95]

As can be seen in Figure 5.4, in a high-competition market, the number of rating issuances of BBB- and above is more than the number of rating issuances of BB+ and below. In contrast, in a low-competition market, the number of issuances of BBB- and above is less than counterparts of BB+ and below; in other words, in a high-competition market, the rating inflation is more obvious. Rating inflation is one typical form of low-quality ratings. According to the common perception, the rating inflation should have improved when the market is more competitive. This comparison of Figure 5.4 does not fit our expectation pertaining to the relationship between market competition and rating quality. One possible explanation is that in a high-competition market, Fitch's suffers more pressure, and it is thus more inclined to use lax rating standards in favour of its clients so as to obtain more businesses. This scenario could be inferred for each CRA in a high-competition market. Which is to say, the chance of rating shopping for the new marker entrants in a high-competition market may be higher.[96] In this regard, one conclusion could be drawn that to improve the rating quality, does not merely increase competition and does not ensure rating quality. In conjunction with the relevant regulatory approaches discussed in Chapter 4, rating shopping at the individual level is easier to manage, while rating shopping at the agency level is not.

[95] ibid.
[96] Rating shopping is discussed in Chapter 4.

For the existing regulations, even though the rating quality cannot be entirely ensured through increasing market competition, there are still many other advantages to enhancing market competition, such as lowering regulatory barriers and regulatory cost. On this basis, a supplementary proposal here is to improve the deficiency in the current regulatory approach. Given that greater competition could motivate CRAs to compete with one another, the existing regulations are deigned to incentivize CRAs to update their rating methodologies, but CRAs tend to lower their rating standards to favour their clients instead of updating models. To avoid potential rating inflation and rating shopping, one additional proposal for the existing regulations is to enhance the supervision for these CRAs that provide positive ratings, such as a AAA rating, too often. Regulators could set a proportion standard for each investment-grade rating level, such as 10 per cent. If one CRA issues too many AA ratings (the issuance of an AA rating is over the 10 per cent of the whole rating issuance), it will become regulatory focus in a certain period. As analysed above, in the failure of the reputation mechanism, it is incumbent upon regulators and markets to create another deterrence. The conditional regulatory focus is designed to become a new deterrence.

Under this proposal, it should be noted that calculating the issuance of rating should not include unsolicited ratings.[97] There are two common reasons for CRAs issuing unsolicited ratings. The one is to charge higher fees for other solicited ratings. An unsolicited rating may bring new business when the unsolicited issuer under pressure of an unfavourable rating pursues a higher rating.[98] Another ground is that CRAs balance inflated solicited ratings as a whole by issuing a lower unsolicited rating. For example, in 1998 Hannover Re, as one of the world's largest reinsurance companies, chose S&P and A.M. Best Company (a smaller CRA) rather than the offer from Moody’s. Then, the credit rating of the Hannover Re by Moody’s was obviously lower than other credit ratings by S&P and A.M. Best Company. Also, the credit rating of Hannover Re by Moody’s was lower than that given by Moody’s before its rejection. With respect to the downgrade in the credit rating by Moody’s, the related information is not sufficient to prove its rationality. Thus, Hannover Re regard it as ‘pure blackmail’.[99] In addition, as Winnie P.H. Poon found in his research, unsolicited credit

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[97] *Unsolicited ratings* could be defined as ‘ratings that CRAs conduct without being formally engaged to do so by the issuer’. See Patrick Van Roy, ‘Is There A Difference between Solicited and Unsolicited Bank Ratings and If So, Why?’ (National Bank of Belgium 2006) Working Paper Research N 27, 1 <https://www.nbb.be/doc/ts/publications/wp/wp79en.pdf> accessed 18 December 2018.

[98] Paolo Fulghieri, Günter Strobl and Han Xia, ‘The Economics of Solicited and Unsolicited Credit Ratings’ (2014) 27 (2) The Review of Financial Studies 484 <https://academic.oup.com/rfs/article/27/2/484/1581201> accessed 18 December 2018.

[99] Lynn Bai, ‘On Regulating Conflicts of Interest in the Credit Rating Industry’ (2010) 13(2) New York University Journal of Legislation and Public Policy 253, 262.

ratings are lower than the solicited credit ratings.[100] Even so, that does not imply that unsolicited ratings have a downward bias. Another valid explanation is that a low-quality entity does not request a credit rating.[101] Therefore, in case a CRA issues too many unsolicited ratings to balance the inflated solicited ratings, the unsolicited rating should not be included when calculating the proportion standard for each rating level.

[100] Winnie P. H. Poon, 'Are Unsolicited Credit Ratings Biased Downward?' (2003) 27(4) Journal of Banking and Finance 593.
[101] Paolo Fulghieri, Günter Strobl and Han Xia (n 98).

Chapter 6: Civil Liability

6.1 Introduction

As demonstrated the negative effects of other issues in the previous chapters,[1] this chapter continues to examine whether or not the current civil liability regime is an effective approach to deter CRAs from their low rating quality. During the 2007–8 financial crisis, CRAs were broadly criticised for their inaccurate rating, and many actions for damages claims against CRAs were brought to the courts. Whether the CRAs should or should not be held liable for their inaccurate rating has often been discussed. The pre-crisis civil liability regime imposed few liabilities on the CRAs, especially when CRAs have no contractual relationships with claimers. However, the civil liability for CRAs became a regulatory focus after the financial crisis. In 2010, the United States introduced expert liability of CRAs under *Dodd–Frank Wall Street Reform and Consumer Protection Act*[2] (hereafter 'Dodd–Frank Act'). In 2013, Regulation (EU) No. 462/2013 (hereafter 'Regulation 2013')[3] introduced the civil liability regime for CRAs in the European regulatory framework. In China, *Securities Law of the People's Republic of China (2014 Amendment)*[4] (hereafter 'Securities Law of China') provides a framework for civil liability in relation to CRAs.

This chapter addresses the role that private law should play in the issues of CRAs. Private law remedies began to be used to supplement the CRA regulation by deterring the misconduct of CRAs and compensating for losses suffered by investors. In general, investors who have no contractual relationships with CRAs are the majority of claimants, based on the allegation that CRAs should be responsible for their ratings that are relied on by investors when making investment decisions. In order to establish civil liability against CRAs, existing private law remedies have many hurdles that need to be overcome. In addition, it also compares the implementations between the public enforcement and private actions in order to determine which one has a more effective deterrence for CRAs. This chapter mainly addresses and critically challenges the approaches to redress claims arising from civil liability regimes in the European Union, United States and China, so as to decipher the

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1 As demonstrated in Chapters 4 and 5, the conflict of interest provides incentives for CRAs to provide inflated rating services and oligopolistic members (namely the big three) lack motivations to update rating models and methodologies.

2 Dodd–Frank Wall Street Reform and Consumer Protection Act 2010 (Public Law 111-203, 111th Congress).

3 Regulation (EU) No. 462/2013 of the European Parliament and of the Council of 21 May 2013 Amending Regulation (EC) No. 1060/2009 on Credit Rating Agencies (OJ 2013 L 146).

4 Securities Law of the People's Republic of China (2014 Amendment) [中华人民共和国证券法(2014 修正)] 2014 (Order No. 14 of the President of the People's Republic of China).

rationales for the introduction of civil liability regimes and to reflect upon future developments.

6.2 The United States

6.2.1 The Approaches to Private Law Remedies

In the United States, when investors were misled by inaccurate credit ratings and suffered loss, they could pursue private law remedies against CRAs. In theory, the possible private law remedies in the US law include several approaches, which are based on securities law, tort law and contract law respectively. However, the effectiveness of these approached needs to be further explored.

If an investor (subscriber) under the investor-pays model (subscriber-pays model) or an issuer under the issuer-pays model sues a CRA, it can hold this rating agency liable under contract law. Credit rating disputes, to a large extent, happens in the absence of contractual relationships. Under contact law, a third-party beneficiary without a contractual relationship can still bring a claim to court against one party to the contact.[5] The third-party beneficiary rule is an exceptional remedy for the general rule of contact law. Therefore, the requisite for the application of the third-party beneficiary rule is whether the contacting parties have or do not have the intention to benefit a third party.[6]

In terms of credit ratings, when an investor has not a contractual relationship with a CRA, the contract between a CRA and an issuer should have express declaration that investors are the beneficiaries, otherwise, investors cannot invoke the third-party beneficiary rule to sue in case of breach of contract.[7] Investors are the end-users of credit ratings in the bond markets. Without the potential purchase or transaction of investors, the credit rating would be valueless for bond markets. Investors are thus third-party beneficiaries irrespective of whether or not there is a declaration on the contact.[8] However, in the case of *Quinn v. the McGraw-Hill Companies,* the court argued that in the absence of express intention, the fact that investors obtained valuable information from rating contracts were not suffice to prove the precondition of the third-party beneficiary rule that contracting parities had the intention

[5] Mohammed Hemraj, CRAs: Self-Regulation, Statutory Regulation and Case Law Regulation in the United States and European Union (Springer 2015).
[6] *XL Disposal Corp v John Sexton Contractors Co* No. 78505. 659 N.E.2d 1312 (Ill. 1995).
[7] *Quinn v the McGraw-Hill Companies* [1999] United States Court of Appeals, Seventh Circuit 168 F.3d 331.
[8] ibid.

to benefit investors.[9] The court explained that even though investors might be the indirect beneficiaries, the argument of investors was not direct evidence to show that they were the direct beneficiary of contracting parties, but a structural view of the role of credit ratings based on the way the bond market operated.[10] In practice, no CRA is willing to issue a declaration that implies intent to benefit investors.

In the case of *Abu Dhabi Commercial Bank v. Morgan Stanley & Co,* plaintiffs attempted to apply the third-party beneficiary rule against rating agencies in a breach of contract claim, but the plaintiffs still failed to draw a reasonable inference through contact provisions in order to prove that the contracting parties had intent to benefit a third party;[11] in other words, it is impossible for investors to receive compensation under the law of contract. Therefore, in this chapter, the possibility of the following approaches, namely common law fraud, tort of negligence and fraudulent misstatement under securities law is discussed.

The first option for investors to recover loss is to bring a common law fraud claim against CRAs. Common law fraud is the 'intentional misrepresentation of material facts presented to and relied upon by another party to his detriment'.[12] In order to prevail a common law fraud, the plaintiffs must show: '(1) a misrepresentation or omission of material fact; (2) which the defendant knew to be false; (3) which the defendant made with the intention of inducing reliance; (4) upon which the plaintiff reasonably relied; and (5) which caused injury to the plaintiff.'[13]

Similar to common law fraud, another option for plaintiffs is to bring a fraudulent misrepresentation claim under securities law. Section 10(b) of Securities Exchange Act of 1934 (hereafter 'Exchange Act') and the Rule 10b-5 further constitutes the statutory approach.[14] Rule 10b-5 also provides an implicit private right of action.[15] To succeed in a

[9] ibid.
[10] ibid.
[11] *Abu Dhabi Commercial Bank v. Morgan Stanley & Co*. [2009] United States District Court, SD New York 651 F. Supp. 2d 155 (S.D.N.Y. 2009).
[12] Mohammed Hemraj, CRAs: Self-Regulation, Statutory Regulation and Case Law Regulation in the United States and European Union (Springer 2015) 183.
[13] *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.* (n 11) 171.
[14] Section 10 of Securities Exchange Act of 1934 (as amended through PL 112- 158, approved August 10, 2012). Section 10(b) is the primary anti-fraud statutory provision, which prohibits 'fraudulent, material misstatements or omissions in connection with the sale or purchase of a security'.
To enforce section 10, the SEC enacts Rule 10b-5 against 'manipulative and deceptive practices' in securities trading. Rule 10b-5 also 'impose[s] liability for any misstatement or omission of a material fact, or one that investors would think was important to their decision to buy or sell a security.'
[15] Carrie Guo, 'Credit Rating Agency Reform: A Review of Dodd–Frank Section 933(B)'s Effect (or Lack Thereof) since Enactment' (2016) 1 Columbia Business Law Review.

security fraud misrepresentation claim, plaintiffs have to prove the misstatement in relation to the transaction of a security that satisfies the following elements: '(1) a misstatement or omission, (2) of a material fact, (3) made with scienter, (4) justifiably relied on by plaintiffs, and (5) proximately causing them injury.'[16] For credit rating cases, the elements under common law fraud are substantially identical to the counterpart under the Rule 10b-5 claim.[17] Thus, in this chapter it is shown that the key impediments are extremely similar in both approaches.

Next, the plaintiff can bring a negligent misrepresentation claim in tort law. As Pinto argued, the tort of negligent misrepresentation may be the possible basis for users of credit ratings.[18] Each state has different elements to be proven for negligent misrepresentation in the United States.[19] For example, the negligent misrepresentation claim plaintiffs in Illinois is required to prove: '(1) a false statement of material fact, (2) carelessness or negligence in ascertaining the truth of the statement by defendant, (3) an intention to induce the other party to act, (4) action by the other party in reliance on the truth of the statements, (5) damage to the other party resulting from such reliance, and (6) a duty owed by defendant to plaintiff to communicate accurate information.'[20] Negligent misrepresentation has similar elements to fraudulent misrepresentation (common law fraud). The obvious difference between fraudulent misrepresentation and negligent misrepresentation is that the statement of negligent misrepresentation is a false statement of fact that needs to be made not with intention but with negligence.[21]Another difference is that, in a negligent misrepresentation claim, defendants should be liable only when they had a breach of duty – this duty required the defendant to be responsible about its statement – that caused damage to the plaintiff who reasonably relied on the statement. [22] In addition, to prevail in a negligent misrepresentation, plaintiffs have to prove other important elements, such as reasonable reliance and proximity.

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[16] *In re National Century* [2008] United States District Court, SD Ohio, Eastern Division 580 F. Supp. 2d 630.
[17] *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.* (n 11) 171.
[18] Arthur R. Pinto, 'Control and Responsibility of CRAs in the United States' (2006) 54(Suppl. 4) The American Journal of Comparative Law.
[19] Rachel Jones, 'The Need for a Negligence Standard of Care for CRAs' 1 (1) William & Mary Business Law Review <https://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1007&context=
wmblr> 227 accessed 20 August 2020.
[20] *Quinn v. the McGraw-Hill Companies* (n 7).
[21] Michael M. Krauss, 'Common Law Fraudulent Misrepresentation and Negligent Misrepresentation' [2019] Business Disputes: Claims and Remedies, 1-1 <https://www.gtlaw.com/en/insights/2015/1/common-law-fraudulent-and-negligent-misrepresentation> accessed 10 October 2020.
[22] *Quinn v. the McGraw-Hill Companies* (n 7).

Section 11 of Securities Act of 1933[23] also provides for a liability arising from false information in a registration statement against CRAs. Section 11 specifies the expert liability arising from the false registration statement, and investors can hold CRAs liable for an 'untrue statement of a material fact or omitted to state a material fact' contained in a registration statement.[24] Nevertheless, in 1981, Rule 436(g) was designed to encourage more NRSROs[25] to disclose their ratings in their registration statements through granting an NRSROs an exemption that the credit rating by this NRSRO was not considered part of a registration statement.[26] Therefore, CRAs were immune from certain liability under Section 11 until the enactment of the Dodd-Frank Act. This will not be discussed until the Dodd-Frank Act part.

6.2.2 The Obstacles within The Approaches

a. The First Obstacle: Freedom of Speech

Before analysing the particular obstacle to each element on both common law fraud and negligent misrepresentation, it needs to be noted the first line of defence for CRAs against a private cause of action is the protection under the First Amendment of the US Constitution.[27] For a the long time, because credit rating was regarded as an opinion and thus not actionable, CRAs were insulated from civil lability due to the constitutional protection under the First Amendment.

Freedom of speech can be dated back to the case of *New York Times Co. v. Sullivan* in 1964. In this case, the US Supreme Court first affirmed 'freedom of speech' for journalists.[28] This offered journalists protection for their statements and they are thus immune from civil suits,

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[23] Section 11 of Securities Act of 1933 (as amended through PL 112-106, approved April 5, 2012, 15 USC § 77a).

[24] Registration statement for securities offering includes a set of documents, namely prospectus and addition information that does not need to disclose to the investors but must file with the relevant regulator. See SEC, 'What Is A Registration Statement?' (29 November 2017) <https://www.sec.gov/smallbusiness/goingpublic/registrationstatement> accessed 10 October 2020.

[25] Nationally recognized statistical rating organization (hereafter 'NRSRO' or 'NRSROs'.)

[26] Rule 436(g)(1) of the Securities Act of 1933, 17 C.F.R. § 230.436(g)(1) (2003).

[27] The First Amendment of the US Constitution states: 'Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the government for a redress of grievances'. See The Constitution of the United States of America as Amended (House Document No 110-50, 2007, 110th Congress, 1st Session). The CRA was regarded as media and, hence, it was protected by the First Amendment for 'freedom of speech'. The issue will be discussed in this section.

[28] *New York Times Co v. Sullivan* [1964] US Supreme Court 376 U.S. 254.

unless the plaintiff can prove that the statement was made with 'actual malice'.[29] Freedom of speech determined through this case was designed to provide protection of speech for the media against public authorities. Later, in the case of *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, the court further provided that in the absence of actual malice, if the defendant's statement did not involve any matter of 'public concern', the defendant could not be protected by freedom of speech under the First Amendment.[30] In this case, the credit rating reports were provided to five subscribers and was thus not in relation to public concern.[31] On this point, credit rating was not protected under the First Amendment.[32]

The two cases constitute the three elements for protection of freedom of speech under the First Amendment: the first one is the speech provider is a journalist or other media; the second is there is no actual malice; and the third is the context of speech is related to public concern.

In the case of credit rating, the third element is the common reasons for courts rejecting constitutional protection to CRAs. The case of *In re National Century* in 2008 illustrates that, given that the credit rating is provided to a 'select class of institutional investors', the defendant cannot get constitutional protection. (However, the plaintiff still failed to prove scienter, as mentioned below).[33] In 2009, another case in which the court rejected First Amendment protection is the *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.* The CRAs (one of the defendants) could not be protected under the First Amendment, because the rated structured financial products were never widely disseminated but, instead, were provided to a select group of investors.[34]

However, CRAs in most relevant cases enjoyed constitutional protection. In 1989, under the *First Equity Corporation of Florida v. Standard & Poor's Corporation,* the court stated that CRAs could be deemed media, such as newspapers, and it was thus not liable for negligent misrepresentation due to the protection under the First Amendment.[35] In 1999, in the case of

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[29] ibid. The US Supreme Court defined *actual malice* as a statement made 'with knowledge that it was false or with reckless disregard of whether it was false or not'. The reason why the US Supreme Court decided to protect 'freedom of speech' is that the 'erroneous statement is inevitable in free debate, and it must be protected if the freedom of expressions are to have the "breathing space" that they need . . . to survive'.
[30] *Dun & Bradstreet, Inc. v Greenmoss Builders,* [1985] US Supreme Court 472 U.S.749.
[31] ibid.
[32] ibid.
[33] *In re National Century* (n 16).
[34] *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.* (n 11).
[35] Judge Goettel provided that 'it is widely recognized that in the absence of a contract, fiduciary relationship, or intent to cause injury, a newspaper publisher is not liable to a member of the public for a non-defamatory

Jefferson County School District v. Moody's Investor's Services, Inc., the court affirmed protection for CRAs under the First Amendment.[36] In this case, the plaintiff failed to prove the falsity of the credit ratings by the defendant, because the court stated that credit rating was deemed an expression of opinions that could not be proven false. The rationale behind this judicial judgement is in order to withstand constitutional protection under the First Amendment, when the statement by a defendant (credit rating) is related to public concern, the only option for the plaintiff is to prove the actual malice. However, the precondition to prove malice is that credit ratings can be proven false. In this case, the court explained that the opinion could be categorized by 'evaluative opinions' or opinions that cannot be proven false and the 'deductive opinions' or opinions that can be proven false, and the credit ratings were categorized as the former.[37] Later, in 2007, the case of *Compuware Corp. v. Moody's Investor Services* also supported the argument. In response to the allegation by Moody's (defendant) that its rating was mere prediction about the financial future of the issuer, the court held that credit rating is not a statement that can be proven false because this prediction was 'inherently subjective nature of Moody's ratings calculations'.[38]

The freedom of speech for credit rating cases essentially protects the efficiency of the financial market by compromising part of investor protection. As Husisian states, the compensation on investors 'must give way to the First Amendment's concern for the free flow of commercial information,' because to hold CRAs operating beyond the negligent threshold should rely on the market and competition instead of courts.[39] In the case of *First Equity Corporation of Florida v. Standard & Poor's Corporation,* the court also affirmed that granting recovery may give rise to claims in relation to the resembling bonds service by the entire public.[40] In other words, once it opens the floodgates, the excessive lawsuits may affect the effective operation of the bonds market and judicial system.

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negligent misstatement of an item of news, "unless he wilfully . . . circulates it knowing it to be false, and it is calculated to and does . . . result in injury to another person."' *First Equity Corporation of Florida v Standard & Poor's Corporation* [1989] United States Court of Appeals, Second Circuit 869 F.2d 175 (2d Cir. 1989).

[36] *Jefferson County School District v. Moody's Investor Services*, Inc 175 F.3d 848, 856 (10th Cir. 1999).

[37] ibid.

[38] *Compuware Corporation v. Moody's Investors Servs, Inc.,* [2007] United States Court of Appeals, Sixth Circuit 499 F.3d 520, (6th Cir.) No. 05-1851. 'A Moody's credit rating is a predictive opinion, dependent on a subjective and discretionary weighing of complex factors. We find no basis upon which we could conclude that the credit rating itself communicates any provably false factual connotation. Even if we could draw any fact-based inferences from this rating, such inferences could not be proven false because of the inherently subjective nature of Moody's ratings calculation.'

[39] Gregory Husisian, 'What Standard of Care Should Govern the World's Shortest Editorials? An Analysis of Bond Rating Agency Liability' (1990) 75 Cornell Law Review, 460 <https://core.ac.uk/download/pdf/216740359.pdf> accessed 28 July 2020.

[40] *First Equity Corporation of Florida v. Standard & Poor's Corporation* (n 35).

As can be seen from the cases above, investors can withstand the constitutional protection by not involving public concern (credit ratings were disseminated to a select class of people) or holding actual malice (the precondition is that credit ratings can be proven false). The former has limited applicable scope and the latter cannot be justified because the courts once regarded credit ratings as opinion. As a result, CRAs are largely immune from civil liability by the protection of the First Amendment.

b. Scienter

Common law fraud has a high degree of proof requirement with respect to state of mind, namely scienter.[41] The court provides the definition of *scienter* as 'a mental state embracing intent to deceive, manipulate, or defraud'.[42] Scienter is used to denote the level of intent of the defendants. In practice, it is hard for a plaintiff to prove the scienter in many civil cases.[43] For example, in the insider trading case of *Rothman v. Gregor*, the fact that the defendant had obtained USD 1.6 million profit is still insufficient to satisfy the scienter requirement.[44]

The high degree of scienter creates an obstacle for plaintiffs to establish civil liability against CRAs. In common law fraud, plaintiffs should prove: '(a) (the speaker) knows or believes that the matter is not as he represents it to be (b) does not have the confidence in the accuracy of his representation that he states or implies; or (c) knows that he does not have the basis for his representation that he states or implies.'[45] In a Rule 10b-5 claim under securities law, it is also difficult for plaintiffs to prove the mental state of defendants. Furthermore, the Private Securities Litigation Reform Act of 1995 (hereafter 'PSLRA') states a stricter pleading standard for a fraud claim under securities law.[46] The PSLRA aims to prevent excessive civil lawsuits for fraud claims under securities law and enhances the protection of corporate defendants in securities lawsuits.[47] In the case of *Tellabs, Inc v. Makor Issues & Rights, Ltd*, the court interpreted the pleading standard of scienter under the PSLRA, which

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[41] 'Scienter (Latin word meaning 'knowingly') is a guilty knowledge that is sufficient to charge a person with the consequences of his or her acts.' See Mohammed Hemraj (n 5).
[42] *Ernst and Ernst v. Hochfelder* [1976] the Unites States Supreme Court 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668.
[43] Thomas M. J. Möllers and Charis Niedorf, 'Regulation and Liability of CRAs: A More Efficient European Law?' (2014) 11(3) European Company and Financial Law Review 333.
[44] *Rothman v. Gregor* 220 F.3d 81 (2d Cir. 2000) 94-5.
[45] American Law Institute, 'Restatement (Second) of Torts', (1977), § 526.
[46] The PSLRA requires a plaintiff alleging securities fraud to 'state with particularity facts giving rise to a strong inference that the defendant[s] acted with the required state of mind'. 15 U.S.C. § 78u-4(b)(2) of Private Securities Litigation Reform Act of 1995 (Public Law 104-67, 104th Congress).
[47] Carrie Guo (n 15) 203-4.

held that 'to qualify as strong an inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent'.[48] As a result, a stringent scienter requirement was further underpinned.

In the case of *In re National Century*, in terms of the scienter under a Rule 10b-5 claim, the court applied the strong inference standard pursuant to the PSLRA.[49] In great detail, the plaintiffs attempted to justify the scienter through the reliance on the case of *LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co.*,[50] but the court held that this reliance was not persuasive, because LaSalle was a pre-PSLRA case, while in the case at issue a stringent pleading standard of scienter under the PSLRA should be applied.[51] The complainant failed to justify scienter, because the plaintiff merely proved that the defendant had access to the documents of rated entities, rather than that the particular information alerted the defendant to knowledge of the fraudulent behaviour of the rated company.[52] That the defendant failed to review the rated entities is insufficient to establish scienter.[53] Furthermore, the plaintiff contended that the defendant had issued a favourable rating in order to maintain a lucrative relationship with the rated company.[54] The court held that the desire to retain the fee from the rated company was not sufficient to draw strong inference of scienter.[55] As a result, the plaintiff failed to satisfy the scienter requirement.

In the recent case of *Tolin v. Standard & Poor's Fin Servs,* the plaintiffs failed to prove scienter in a common law fraud claim that the defendant had not believed its ratings when it issued them.[56] The allegation merely explained that defendants have motivation to issue a favourable rating, but did not prove what the defendant's state of mind was at the time it made each particular ratings.[57] In 2012, in the case of *Ohio Police & Fire Pension Fund v. Standard & Poor's Financial Services LLC (*hereafter *'Ohio Police')*, the plaintiffs failed to show scienter, on tort of negligence, that the defendant did not believe its ratings.[58]

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48 *Tellabs, Inc v. Makor Issues & Rights*, Ltd [2007] Supreme Court of the Unite States 551 U.S. 308,314.
49 *In re National Century* (n 16) 641.
50 *LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co*., 951 F. Supp. 1071 (S.D.N.Y.1996).
51 *In re National Century* (n 16) 642.
52 ibid 643.
53 ibid 643–4.
54 ibid 644.
55 ibid.
56 *Tolin v. Standard & Poor's Fin Servs* [2013] United States District Court, SD New York 950 F. Supp. 2d 714 (S.D.N.Y. 2013) 722.
57 For example, a particular rating analyst of a defendant who was responsible for formulating a rating did not believe the rating it had given. ibid.
58 *Ohio Police & Fire Pension Fund v. Standard & Poor's Financial Services* LLC [2012] United States Court of Appeals, Sixth Circuit 700 F.3d 829, 700 F.3d 829.

Insider trading cases, also pursuant to the PSLRA and Rule 10b-5, have established a set of standards to prove scienter: 'either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehaviour or recklessness.'[59] In another case of *Novak v. Kasaks*, the court provides strong inference of scienter more specifically: '(1) benefitted in a concrete and personal way from the purported fraud; (2) engaged in deliberately illegal behaviour; (3) knew facts or had access to information suggesting that their public statements were not accurate; or (4) failed to check information they had a duty to monitor'.[60] Among these, the first one is the same as the first standard in *Kalnit v. Eichler* and the others specifically address the second standard in *Kalnit v. Eichler.*

The case of *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.* showed that scienter could be satisfied. In this case, the plaintiffs succeeded in justifying scienter in three respects: first, conflicts of interest existed between the CRAs and the issuers of rated structured financial products. Second, CRAs held some critical non-public information that was contradictory to the high ratings, but the CRAs never updated their ratings. For example, ratings agencies knew the portfolios consisted of much more than 55 per cent Residential Mortgage-Backed Securities (hereafter 'RMBSs') that did not conform to the statement that 'no more than 55 per cent of RMBSs' as set out in Information Memoranda. Third, CRAs applied lax models to these complex structured financial products. This case applied the first standard established for inside trading, as mentioned above, and successfully fulfilled the scienter requirement by proving the defendant's motive and opportunity to assign misleading ratings.

In 2009, another credit rating case of In re *Moody's Corp. Securities Litigation* also applied the same standards to a Rule 10b-5 claim.[61] Even though the plaintiff failed to show that Moody's had the motive and opportunity to commit deceit, it successfully proved the scienter through a specific statement indicating that the top officials of the defendant were cognizant that its independency, ratings and rating methodologies had been compromised.[62] This also conforms to the third standard in the *Novak v. Kasaks.*

[59] *Kalnit v. Eichler* 264 F.3d 131 (2d Cir. 2001)138.
[60] *Novak v. Kasaks* 216 F.3d 300 (2d Cir. 2000) 311.
[61] In r*e Moody's Corp Securities Litigation* 599 F. Supp. 2d 493 (S.D.N.Y. 2009) 516.
[62] ibid.

As can be seen from all the cases mentioned above, scienter has a high degree of proof requirement on fraud claims and negligent misrepresentation. Especially for the fraud claims, the insider trading standards provide an approach to proving scienter. In terms of the motive and opportunity to fraud, the reason why the single motive cannot suffice to scienter is that this pressure that CRAs generally suffered is 'a systemic problem' and widespread through the whole rating industry. One possible concern for the court is that once the court accepts this kind of allegation of motivation regarding the scienter requirement, there numerous lawsuits will follow on for this allegation. Next, the *Novak v. Kasaks* case further specifies that the strong inference of scienter in fraud claims could be established by pleading either motive and opportunity that a defendant has (the simple pleading of motive and opportunity may be rejected by the court), or the strong circumstantial evidence of conscious misbehaviour or recklessness.[63] As a result, scienter is a tough obstacle within all the approaches. Importantly, the new scienter under 933b of the Dodd–Frank Act is more stringent, as will be discussed below.

c. Reliance

In order to prevail in a common law fraud or negligent misrepresentation claim, plaintiffs have to show reasonable reliance.[64] For the lawsuit against CRAs, investors have to prove that their reliance on the credit rating was foreseeable and justifiable.[65]

Another reference arising from insider trading is the fraud-on-the-market theory. The fraud-on-the-market theory[66] is applied to determine the reliance on a security fraud claim. To invoke the presumption of reliance based on fraud-on-the-market theory, a plaintiff should demonstrate: 'first, the defendants made public misrepresentations; second, the misrepresentations were material; third, the stock was traded on an efficient market; fourth, the misrepresentations would induce a reasonable, relying investor to misjudge the value of the stock; fifth, the plaintiff traded in the stock between the time the misrepresentations were made and the time the truth was revealed'.[67] US courts commonly accept the third element.[68]

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[63] *Novak v. Kasaks* (n 60) 310.
[64] *Kuch Watson, Inc v. Woodman* 331 N.E.2d 350, 354 (Ill.App.Ct. 1975) 354.
[65] *Perschall v Raney* 484 N.E.2d 1286 (Ill.App.Ct. 1985) 1290.
[66] 'Fraud-on-the-market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements'. See *Peil v. Speiser*, 806 F. 2d 1154 (CA3 1986) 1160-1.
[67] *Levinson v. Basic Inc*. 786 F.2d 741 (6th Cir. 1986) 750.
[68] ibid.

A defendant can rebut the presumption by showing that either the misrepresentation did not cause a distortion in the stock price,[69] or that the stock price remained the same as before when the misrepresentation was disclosed.[70]

In the credit rating case of In re *Moody's Corp. Securities Litigation,* on a Rule 10b-5 claim, Moody's rebutted the fraud-on-the-market presumption of reliance by showing that there is no statistically link between changes in the stock price and the any alleged misrepresentation. Which is to say, the alleged misrepresentation did not lead any distortion in price, because the market had knowledge of the potential conflicts and absorbed the false information.[71] Therefore, the plaintiffs failed to prove the reliance.

By contrast, another case provides a positive example to meet the reliance requirement. In a common law fraud claim of *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*, the motion that the plaintiff relied on the alleged credit ratings was granted, because the court considered the factors as below:'(1)the complexity and magnitude of rated structured financial products; (2) such critical information that CRAs hold even the sophisticated investors cannot obtain; (3) the NRSRO status that most market participants rely on their ratings'.[72] It should be noted that the court did not apply the fraud-on-the-market in this case because this theory is commonly adopted in securities fraud claims.

On a negligence of tort claim, the plaintiff also should prove the reliance element. The reliance in tort of negligence must be shown to have been reasonable. In this regard, the proof requirement of reasonable reliance in negligent misrepresentation claim is higher than that in (securities) fraud claim. For example, in the case of *Quinn v. the McGraw-Hill Companies*, When the plaintiff purchased the debt instrument, the credit rating of the debt instrument was 'A' ; later, while S&P (defendant) downgraded the rating, the plaintiff lost plenty of money.[73] The plaintiff failed to prove its reasonable reliance, not only because when it decided to purchase the debt instrument, its decision was merely based on the 'A' rating rather than the whole actual representation of S&P, but also because the issuer of the debt instrument informed the plaintiff that the debt instrument contained substantial risks.[74]

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[69] *Basic Inc. v. Levinson* 485 U.S. 224 (1988) 108 S. Ct. 978, 248-49.
[70] In *re American Intern Group*, Inc Sec Litig 265 F.R.D. 157 (S.D.N.Y. 2010) 180.
[71] *In re Moody's Corp Securities Litigation* 274 F.R.D. 480 (S.D.N.Y. 2011) 493.
[72] *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.* (n 11).
[73] *Quinn v. the McGraw-Hill Companies* (n 7) 333.
[74] ibid 336.

Therefore, the court decided that in this case reliance on the credit rating of the investment was not reasonable.

In short, the plaintiffs are faced with an extremely high burden of proof in the reliance element. On the Rule 10b-5 claim, the fraud-on-the-market theory serves as the presumption of reliance. However, some doubts have been cast on the application of the fraud-on-the-market theory in credit rating cases. The application of the fraud-on-the-market theory aims to reduce the burden of proof for plaintiffs by reversing part of the burden on defendants. In credit rating cases, given that the bond market is less efficient than the stock market,[75] it is less difficult for defendants to rebut the presumption of reliance by proving that there is no causal link between the alleged misrepresentation and the stock price. This is opposite to the original objective. On the tort of negligence, the requirement of reliance is more like an *ex. ante* guideline, which requires plaintiffs to show the evidence that they did undertake their own due diligence prior to the investment. Associating with the US regulations to reduce the over-reliance of the market participants, both rules encouraged investors not to solely rely on credit ratings. However, the existing cases have not provided a clear standard for plaintiffs on how to justify reasonable reliance on the tort of negligence. As a result, the reliance appears a major hurdle in civil liability claims against CRAs.

d. Duty of Care or Privity

In order to prevail in a negligent misrepresentation, a plaintiff should prove that the defendant owed a duty of care to communicate accurately.[76] In the United States, there are various ways to determine duty of care in various states. For example, in the state of New York, a plaintiff should prove the near-privity relationship between itself and a defendant in a negligent misrepresentation claim under tort law.[77] In terms of credit rating cases, it is difficult to prove the privity between a common investor and a CRA. In the case of *First Equity Corporation of Florida v. Standard & Poor's Corporation*, the plaintiff was one of the subscribers of a CRA (defendant), but it failed to prove the privity between itself and the CRA on a tort of negligence.[78] In this case, the court carefully avoided exposing (such as accountants) 'a liability in an indeterminate amount for an indeterminate time to an

[75] Deryn Darcy, 'Credit Rating Agencies and the Credit Crisis: How the Issuer Pays Conflict Contributed and What Regulators Might Do about It.' (2009) 2 Columbia Business Law Review 605, 656.
[76] *Quinn v. the McGraw-Hill Companies* (n 7).
[77] *Anschutz Corp v. Merrill Lynch & Co.* 690 F3d 98 (2d Cir2012) 114.
[78] *First Equity Corporation of Florida v. Standard & Poor's Corporation* (n 35).

indeterminate class'.[79] The court compared a CRA to an accountant or a newspaper publisher,[80] and argued that whatever the relationship between a subscriber it more resembled a reader and a publisher or an accountant, and the court would decline to extent the liability of a CRA, because granting this recovery may expose the whole credit rating service to claims by the entire public.[81]

Another example is in the state of Ohio, to determine whether or not the duty of care existed, the court argued that the liability was imposed (for negligent misrepresentation) only if the provider of information intended to disseminate the information to a limited group of people.[82] The court also explained in the case of *Picker Intern, Inc v. Mayo Found* that a special relationship, as a core requirement for negligent misrepresentation, should exist under which the defendant provided information to the plaintiff and this information was utilized as guidance for plaintiffs in business transactions.[83] For instance, accountants owe a duty of care not only to their clients, but also to any 'third party that is a member of a limited class whose reliance on the accountant's representation is specifically foreseen'.[84] In contrast, a newspaper reader[85] or a radio listener[86] is not a limited class and they therefore cannot hold the newspaper publisher or radio show liable for negligent misrepresentation.

In essence, the *modus operandi* of law in both the states of New York and Ohio are similar. They both require having a special relationship or proximity between plaintiffs and defendants. However, this requirement is far more difficult to achieve for investors suing CRAs in the absence of a contractual relationship. The duty of care derives from a special relationship between the CRAs and some particular investors. In order to justify the special relationship, a plaintiff can prove that a CRA just offered ratings to a limited group of investors. In the *Ohio Police* case in 2012, the plaintiffs failed to prove that they were a 'limited' group of qualitied investors and the CRA (defendant) thus did not owe a duty of care.[87] On this point, the requirement of privity and the requirement of public concern to withstand constitutional protection bear a resemblance. However, this privity element nearly

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[79] *Ultramares Corp v. Touche* 255 N.Y. 170, 174 N.E. 441(1931) 446.
[80] '(An) accountant typically entails a report concerning a single company disseminated to an interested public consisting largely of professionals, (while) a newspaper publisher entails reports on numerous matters to the general public.' *First Equity Corporation of Florida v. Standard & Poor's Corporation* (n 35).
[81] The court stated that 'granting recovery would expose the ticker service to claims by the entire public'. ibid.
[82] *Amann v Clear Channel Communications* 165 Ohio App. 3d 291 (Ohio Ct. App. 2006) 2006 Ohio 714, 297.
[83] *Picker Intern, Inc. v. Mayo Found* 6 F.Supp.2d 685 (N. D. Ohio 1998) 689.
[84] *Haddon View Investment Co. v. Coopers Lybrand* 70 Ohio St. 2d 154 (Ohio 1982) 436 N.E.2d 212,215.
[85] *Gutter v. Dow Jones, Inc.,* 490 N.E.2d 898 (Ohio 1986)900.
[86] *Amann v. Clear Channel Communications* (n 81) 299.
[87] *Ohio Police & Fire Pension Fund v. Standard & Poor's Financial Services LLC* (n 58).

shields an indeterminate common investor without contracts from asking for a civil law remedy against a CRA on tort of negligence.

For the foregoing impediments, it is less possible for plaintiffs without contractual relationships to establish a civil liability against CRAs on the approaches above. Fraud claims (common law fraud and Rule 10b-5 claims) are faced with a high level of scienter. Even though credit rating cases borrow their standards from insider trading, the scienter requirement on securities fraud claims appears still far more severe. The First Amendment, in fact, limits the scope of private law remedies, because the most common way to withstand constitutional protection is to prove that credit ratings are disseminated to a limited group of people. This is also the requirement to establish a special relationship for duty of care on tort of negligence. Expert liability may be a breakthrough for the duty of care and privity. However, the Dodd–Frank Act failed to establish a defined expert liability for CRAs. This will be discussed as follows:

6.2.3 An Attempt to Reduce Obstacles: The Dodd–Frank Act

In 2010, the Dodd–Frank act aimed to introduce an expert liability regime of CRAs and reduce some obstacles to the approaches to remedies, as listed above. At first, according to section 933(a) of the Dodd–Frank Act, CRAs should be held accountable the same as accounting firms or securities analysts under securities law.[88] Section 931(3) found credit rating to be 'fundamentally commercial' in character.[89] In addition, section 931 recognised that the role of a CRA should be regarded as 'gatekeeper' in the financial market,[90] and it thus should be subject to the same standard of accountability as other gatekeepers.[91] Considering the difference between CRAs and accounting firms or securities analysts, rating analysts focus on the assessment for the backward performance that is evaluative, while accountants or auditors focus more on the verification of past performance that is deductive; the same standard of accountability for CRAs can apply in different contexts. Nevertheless,

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[88] Section 933(a)(m)(1) of the Dodd–Frank Act provides: 'The enforcement and penalty provisions of this title shall apply to statements made by a CRA in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws, and such statements shall not be deemed forward-looking statements for the purposes of section 21E.'

[89] Section 931 of the Dodd–Frank Act, which provides: 'Because CRAs perform evaluative and analytical services on behalf of clients, much as other financial ''gatekeepers'' do, the activities of CRAs are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers.'

[90] Section 931(2) and (3) of the Dodd–Frank Act, which states that 'CRAs, including nationally recognized statistical rating organizations, play a critical ''gatekeeper'' role in the debt market that is functionally similar to that of securities analysts, who evaluate the quality of securities in the equity market, and auditors, who review the financial statements of firms. Such role justifies a similar level of public oversight and accountability.'

[91] Section 933(a)(m)(1) of the Dodd–Frank Act.

the Dodd–Frank Act did not clarify what kind of gatekeeper liability should be imposed on CRAs, or at least draw a scope of the professional liability.

Besides, the Dodd–Frank Act aims to mitigate the difficulties for scienter in securities fraud claims against CRAs (namely Rule 10b-5). According to the section 933(b),[92] CRAs have two options, namely (i) conducting reasonable investigations or (ii) obtaining reasonable verification, otherwise in private actions against CRAs, a strong inference of scienter could be made. As a response, some CRAs have adopted corporate codes of reasonable investigation of factual elements.[93] In terms of reasonable verification, CRAs prefer to delegate the duty of investigation to other sources in order to avoid potential risks in litigation.[94] Even though CRAs still need to do the necessary verification of the due diligence service rendered by third parties, they soften the degree of liability for inaccurate verification through outsourcing investigations, because the requirement of verification, such as the sampling technique, is less stringent. The highly possible result will be that they shifted duty of actual or constructive cognizance to duty of reasonable verification. In this regard, it seems still difficult for plaintiffs to demonstrate scienter. In short, compared to the scienter standards[95] established in insider trading, section 933(b) does not radically reduce the burden of proof of scienter.

For liability in the registration statement, section 939G of the Dodd–Frank Act nullified the exemption for NRSROs under Rule 436(g) and made CRAs liable under section 11 of the Securities Law of 1933. As mentioned above, the exemption of Rule 436(g) shielded CRAs from expert liability in the registration statement prior to the Dodd–Frank Act. Apparently, this rule targeted the establishment of expert liability, at least in the registration statement. However, as a response to the repeal of Rule 436(g), CRAs refused to be content with

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[92] Section 933(b) of the Dodd–Frank Act, which provides that 'EXCEPTION.— In the case of an action for money damages brought against a CRA or a controlling person under this title, it shall be sufficient, for purposes of pleading any required state of mind in relation to such action, that the complaint state with particularity facts giving rise to a strong inference that the CRA knowingly or recklessly failed— (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the CRA considered to be competent and that were independent of the issuer and underwriter.'

[93] Andrea Miglionico (n 21) 219; Carrie Guo (n 15) 209.

[94] Andrea Miglionico (n 21) 219.

[95] As mentioned above, scienter standards can be satisfied by: 'either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.' The strong circumstantial evidence of scienter includes: 'engaged in deliberately illegal behaviour; or knew facts or had access to information suggesting that their public statements were not accurate; or failed to check information they had a duty to monitor'.

including their ratings in their registration statement. As a consequence, the market of asset-backed securities (hereafter 'ABSs') almost froze following the repeal.[96] In order to facilitate the normal operation of the ABS market, the US Committee on Financial Services approved the removal of expert liability for CRAs (no action relief) in 2011.[97] As a result, CRAs undertake expert liability under section 11, depending on whether or not they consent to have their rating contained in registration statement.

In short, the effectiveness of the Dodd–Frank Act with regard to establishing civil liability against CRAs has fallen short in expectation. First, it did not provide what kind of expert liability is required for CRAs. Considering the fact that the role of CRAs are different from other gatekeepers (i.e., accountants and auditors), the scope and content of CRAs' expert liability should be defined. Second, scienter remains an obstacle to be proven given section 933(b). Last, the Dodd–Frank Act has no effect on establishing expert liability in a registration statement due to the no action letter.

6.2.4 Settlements Against Credit Rating Agencies

In terms of Public Enforcement,[98] in 2015, the US Department of Justice and 19 state governments along with the District of Columbia sued S&P and its parent corporation McGraw Hill Financial Inc., based on the allegation that investors incurred substantial losses on structured financial products, such as RMBSs and Collateralized Debt Obligations (hereafter 'CDOs'), for which S&P issued over-high ratings that misrepresented the actual credit risk of such financial products.[99] In this case, the complaint was in accordance with the Financial Institutions Reform, Recovery, and Enforcement Act (hereafter 'FIRREA'), the complaint alleged that the defendants had perpetrated some misconduct in violation of

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96 Ford Motor Credit Company LLC, 'SEC No-Action Letter' (22 July 2010) <https://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120-incoming.pdf> accessed 1 August 2020.; see also Benjamin H. Brownlow, 'Rating Agency Reform: Presenting the Registered Market for Asset-Backed Securities' 15 North Carolina Banking Institute 132.

97 SEC, 'Response of the Office of Chief Counsel Division of Corporation Finance' (23 November 2010) <https://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm> accessed 1 August 2020.

98 The two following cases are based on the public laws, such as the 18 U.S. Code § 1341 and 12 U.S.C. § 1833.

99 The United States Department of Justice, Office of Public Affairs, 'Justice Department and State Partners Secure $1.375 Billion Settlement with S&P for Defrauding Investors in the Lead Up to the Financial Crisis' (3 February 2015) <https://www.justice.gov/opa/pr/justice-department-and-state-partners-secure-1375-billion-settlement-sp-defrauding-investors> accessed 28 July 2020.

three forms of fraud.[100] In another case, also pursuant to the FIRRA[101] and other state laws, the Department of Justice and 21 state governments, along with the District of Columbia, sued Moody's on the allegation that the inflated rating provided by Moody's[102] on structured financial products, including RMBSs and CDOs, exacerbated the financial crisis of 2007–8.[103] In this case, based on the investigation, the defendant had to acknowledge that its conducts violated its internal corporate code.[104] However, both cases reached settlement agreements in the end, with the penalty of USD 1,375 billion and USD 864 million respectively.[105]

Both cases mentioned above are mainly based on administrative laws and finally reached settlement agreements. A settlement plays a significant role in enforcement in the United States, whose main benefit is more efficient to complete the enforcement action at a lower cost, to underpin the deterrence effect of enforcement and to provide claimants with compensations.[106] As MacNeil observed: 'settlement procedures are commonly under close scrutiny, particularly in the United States where concern has been expressed that settlements do not achieve adequate accountability or deterrence when they are made without admission of guilt.' However, at first, even though CRAs do not need to admit guilt, they still pay much in settlement agreements. The huge cost for settlement agreements has the moderate effect of deterrence against the misconduct of CRAs in future. In this regard, administrative enforcement is more effective than private law actions. Besides, the acknowledgements by the CRAs prove the existence of rating misconducts, which at least encourages both public and private claimants to pursue their compensation for damages. However, settlement could

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100 These violations include mail fraud under 18 U.S. Code § 1341, wire fraud under 18 U.S.C. § 1343 and financial institutions fraud under 18 U.S.C. § 1344. See in the United States Department of Justice, Office of Public Affairs, 'Department of Justice Sues Standard & Poor's for Fraud in Rating Mortgage-Backed Securities in the Years Leading Up to the Financial Crisis' (5 February 2013) <https://www.justice.gov/opa/pr/department-justice-sues-standard-poor-s-fraud-rating-mortgage-backed-securities-years-leading> accessed 10 October 2020.

101 One of the legal bases of this cases is civil penalties 12 U.S.C. § 1833

102 Moody's here includes Moody's Investors Service Inc., Moody's Analytics Inc., and their parent, Moody's Corporation.

103 the United States Department of Justice, Office of Public Affairs, 'Justice Department and State Partners Secure Nearly $864 Million Settlement With Moody's Arising From Conduct in the Lead up to the Financial Crisis' (13 January 2017) <https://www.justice.gov/opa/pr/justice-department-and-state-partners-secure-nearly-864-million-settlement-moody-s-arising> accessed 28 July 2020.

104 ibid.

105 The United States Department of Justice, Office of Public Affairs, 'Justice Department and State Partners Secure $1.375 Billion Settlement with S&P for Defrauding Investors in the Lead Up to the Financial Crisis' (n 98).; the United States Department of Justice, Office of Public Affairs, 'Justice Department and State Partners Secure Nearly $864 Million Settlement With Moody's Arising From Conduct in the Lead up to the Financial Crisis' (n 103).

106 Iain MacNeil, 'Enforcement and Sanctioning' in Niamh Moloney, Eilìs Ferran and Jennifer Payne (ed), The Oxford Handbook of Financial Regulation (Oxford University Press 2015) 299.

be regarded as a compromise of formal enforcement. Without judgment, these cases cannot provide extensive facts to be discussed further.

Regulators have a part in common motivation with the courts. The regulatory priority is the effective operation of market as well. Compared to the court, the difference for the regulators is that they have a great incentive to rebuild the confidence of investors and improve financial stability after the financial crisis of 2007. Regulatory techniques are more flexible than the law. The civil liability regime of CRAs under the Dodd–Frank Act is more like a temporary threat rather than fundamental reform. The regulatory object is to deter CRAs and make them behave well. In this regard, the administrative penalties have a better influence than private litigation. Hence, the next regulatory focus may be public enforcement rather the private law remedies.

6.3 European Union

6.3.1 The European Union Civil Liability Regime

The current EU regulation governing CRAs is still far from satisfactory. Under contract law (or at least general rules of contract law), issuers or subscribers (investors) can hold CRAs liable for breach of contract when they have contractual relationships with CRAs;[107] in other words, the relevant contract laws or general rules of contract law in member states will apply to these contractual relationships. However, for credit rating cases, most disputes arise between investors and CRAs in the absence of contractual relationships,[108] which situation is quite common under the issuer-pays model.[109]

Leading up to the financial crisis, among the EU member states, there was no specific legislation governing the civil liability of CRAs.[110] Hence, the question becomes what legal

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107 Brigatte Haar, 'Civil Liability of Credit Rating Agencies after CRA 3– Regulatory All-or-Nothing Approaches Between Immunity and Over-Deterrence' (Center of Excellence, Sustainable Architecture for Finance in Europe, White Paper Series No1 2013) 3 <https://safe-frankfurt.de/uploads/media/Haar_Civil_Liability_of_CRA_01.pdf> accessed 10 October 2020.

108 ibid.

109 European Commission, 'IMPACT ASSESSMENT Accompanying the Document Proposal for a Regulation Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies and a Proposal for a Directive Amending Directive 2009/65/EC on Coordination on Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers' Commssion Staff Working Paper SEC (2011) 1354/F1, 142 <https://ec.europa.eu/transparency/regdoc/rep/2/2011/EN/SEC-2011-1354-F1-EN-MAIN-PART-1.PDF> accessed 10 October 2020.

110 ibid.

basis could be relied on when investors bring actions to the court against CRAs. In the absence of contractual relationships, there is high uncertainty when investors claim damage caused by flawed ratings. In some EU member states, such as Sweden and Poland, investors cannot claim damage against CRAs, when there is no contractual relationship between the investors and CRAs, even though this situation is quite common under the issuer-pays model.[111] In the United Kingdom, in the presence of contractual relationships, the liability of CRAs could be determined,[112] while in the absence of contractual relationships, it is uncertain how to determine the duty of care of CRAs vis-à-vis investors, and courts take a flexible approach depending on the particular circumstances of the case.[113] As discussed in the section on the United States, there is a similar debate in Germany with respect to the third-party beneficiary rule of contract law. The key point is whether investors can be regarded as third parties of contracts between issuers and CRAs, and hence ask for protection due to the potential implicit agreement of such contracts. The German mainstream approach is that the protection for third parties in contracts should not be extended to investors without contractual relationships with CRAs.[114] Similar to the United States, the major ground is a lack of explicit intention to benefit investors from the agreements between issuers and CRAs.[115]

In order to further determine the civil liability of CRAs and provide a redress for investors and issuers without contractual relationships, the Regulation 2013 introduced civil lability for CRAs into the regulatory framework.[116] Article 35a of the Regulation 2013 creates a private law remedy for investors and issuers when an investor relies on a rating issued in breach of Regulation (EC) No. 1060/2009 (hereafter Regulation 2009)[117] or the issuer suffers damage caused by a breach of the Regulation 2009, irrespective of contractual relationships between both parties and CRAs.[118] Considering the difficulty for both investors and issuers

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111 ibid.

112 Carsten Thomas Ebenroth and Thomas J Dillon Jr, 'The International Rating Game: An Analysis of The Liability of Rating Agencies in Europe, England, and The United States' (1993) 24(3) Law and policy in international business 783, 789-90

113 European Commission (n 109).

114 Brigatte Haar (n 106) 3-4.

115 ibid 4 .

116 Article 35a of the Regulation 2013

117 Regulation (EC) No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies (OJ 2009 L 302).

118 Article 35a of the Regulation 2013 states that '1. Where a credit rating agency has committed, intentionally or with gross negligence, any of the infringements listed in Annex III having an impact on a credit rating, an investor or issuer may claim damages from that credit rating agency for damage caused to it due to that infringement. An investor may claim damages under this Article where it establishes that it has reasonably

to establish a civil liability in the absence of contractual relationship, the European Union created the civil liability regime that aims to provide a legal approach of redress for investors. This right of redress extends to the circumstance in which there is no contractual relationships between investors or issuers and CRAs.[119] The four basic elements of the EU civil liability regime for CRAs will be discussed next.

a. Duty and Breach of Duty

Article 35a (1) requires CRAs to be held liable for their 'intentional' or 'gross negligent'[120] infringement. All the specific infringements are listed in Annex III of the Regulation 2013. In other words, the EU civil liability regime chooses to provide specific breaches of duty rather than explain what the duty is – as the legal basis on which an investor can rely for the claim of damage – especially in the absence of contractual relationships. However, Article 35a(5) does not exclude further civil liability claims according to national law.[121] Besides, given that the differences in national laws in member states, the Regulation 2013 requires each member state to maintain national civil liability regimes which are more favourable for

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relied, in accordance with Article 5a(1) or otherwise with due care, on a credit rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating.
An issuer may claim damages under this Article where it establishes that it or its financial instruments are covered by that credit rating and the infringement was not caused by misleading and inaccurate information provided by the issuer to the credit rating agency, directly or through information publicly available.
2. It shall be the responsibility of the investor or issuer to present accurate and detailed information indicating that the credit rating agency has committed an infringement of this Regulation, and that that infringement had an impact on the credit rating issued.
What constitutes accurate and detailed information shall be assessed by the competent national court, taking into consideration that the investor or issuer may not have access to information which is purely within the sphere of the credit rating agency.
3. The civil liability of credit rating agencies, as referred to in paragraph 1, shall only be limited in advance where that limitation is:
(a) reasonable and proportionate; and
(b) allowed by the applicable national law in accordance with paragraph 4.
Any limitation that does not comply with the first subparagraph, or any exclusion of civil liability shall be deprived of any legal effect.
4. Terms such as "damage", "intention", "gross negligence", "reasonably relied", "due care", "impact", "reasonable" and "proportionate" which are referred to in this Article but are not defined, shall be interpreted and applied in accordance with the applicable national law as determined by the relevant rules of private international law. Matters concerning the civil liability of a credit rating agency which are not covered by this Regulation shall be governed by the applicable national law as determined by the relevant rules of private international law. The court that is competent to decide on a claim for civil liability brought by an investor or issuer shall be determined by the relevant rules of private international law. …'

[119] Recital 5 in the preamble of the Regulation 2013

[120] The Regulation 2013 does not define many important terms, including *gross negligence*, and it allows national courts to define these terms. See Article 35a (4) of the Regulation 2013. For example, the United Kingdom provides the definition of *gross negligence'* as: it 'ascribes to 'gross negligence' the meaning of recklessness which is well-established concept in the UK law'. See Explanatory Memorandum to the Credit Rating Agencies (Civil Liability) Regulations 2013 2013 (2013 No1637) para 7.5.

[121] Article 35a(5) of the Regulation 2013.

investors or issuers without contractual relationships.[122] This at least implies that the EU approach aims to enhance the civil liability of CRAs, in order to protect parties that use credit ratings. The rationale is that considering the difficulties that investors and issuers are faced with when both parties force CRAs to conduct themselves responsibility, especially in the absence of contractual relationships, the favourable civil liability regime targets a better balance of the interests of the users of ratings and CRAs in the securities market.

In fact, the Regulation 2013 merely created a private enforcement regime for redress rather than establish a duty to extend the existing civil liability for CRAs in the absence of contractual relationships. The contractual liability is not severely affected by Article 35a. On this point, CRAs are prone to pre-emptively limit their civil liability in contract, only if the limitation is reasonable and proportionate. This may bring a rise in the use of exemption terms in format contracts of rating services. In addition, Article 35a (4) leaves much to the discretion of the member states. This gives rise to an inconsistency among different jurisdictions throughout the European Union, as will be discussed below.

b. Reliance

According to Article 35a (1), the reliance requirement for claiming damage by investors is that the investment decision of investors is reasonably based on credit rating on a legally admissible basis.[123] The reasonable reliance is one of necessary conditions for the causation, as discussed below. In order to prove reasonable reliance, an investor has to prove the due care it conducted when it relied on a credit rating before making a decision.

For one thing, Article 5 required financial institutions to make their own credit rating.[124] In the case of financial institutions,[125] they have to prove that they conducted their due credit risk assessment and did not solely rely on their credit rating. These mentioned financial institutions, including institutional investors, are the groups who are most likely to claim damage against CRAs.[126] Nevertheless, the problem is that these provisions are, in fact,

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[122] Recital 35 of the Regulation 2013

[123] Article 32 of the Regulation 2013 provides: 'An investor may claim damages under this Article where it establishes that it has reasonably relied, in accordance with Article 5a(1) or otherwise with due care, on a credit rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating.'

[124] Article 5a (1) of the Regulation 2013 states that 'the entities referred to in the first subparagraph of Article 4(1) shall make their own credit risk assessment and shall not solely or mechanistically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument.

[125] The financial institutions are listed in Article 4(1) of the Regulation 2013.

[126] Thomas M. J. Möllers and Charis Niedorf, 'Regulation and Liability of Credit Rating Agencies – A More Efficient European Law?' (2014) 11(3) European Company and Financial Law Review 333, 347.

contradictory. There are two possibilities: first, if their own credit risk easement is the same as the external credit ratings and they choose to rely on credit ratings, how do they prove that the damage is caused by their reliance on credit ratings rather than their own risk assessment? Second, if their own credit risk assessment is different from the credit ratings and, in general, they are more likely to choose to rely on the credit ratings, how do they prove that the reliance is reasonable?

For another, individual investors are not included in accordance with Article 4(1) and they thus do not undertake due risk assessment. In other words, the requirement of reasonable reliance for them is merely to prove the due care that they exercised in their investment decision or the reasonableness that they solely relied on the external credit ratings. In practice, it is apparently difficult for individual investors to justify their reliance. Some researchers observe that, to some extent, it is impossible to prove the exclusivity where there is media converge whether or not the information does conform to credit ratings.[127]

Apart from that, there is the absence of definition regarding 'reasonable reliance'. The high threshold of reasonable reliance, as a supplement for the EU regulation, targets reducing the over-reliance of market participants on external credit ratings. As a result, these reliance requirements in essence limits the redress for both institutional and individual investors, as well as limits the civil liability of CRAs.

c. Burden of Proof

Burden of proof in the Regulation 2013 can be regarded as another factor to restrict the civil liability regime. At first, in order to ensure the effective redress for investors against CRAs, the 2011 proposal attempted to partially reverse the burden of proof on CRAs, because investors cannot access the information on internal procedures.[128] Based on the 2011 proposal, the burden of proof was partly transferred to CRAs pertaining to the existence of an infringement and the impact of infringement on the rating outcome, while the burden of proof regarding the damage the causation between the breach of duty and damage is still imposed on plaintiffs, such as investors.[129] As can be seen from the Regulation 2013 and

[127] ibid.
[128] European Commission, 'Proposal for a Regulation of The European Parliament and of the Council Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies' (2011) 747 final 2011/0361 (COD), paragraph 26, <https://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0747:FIN:EN:PDF> accessed 10 October 2020.
[129] ibid.

other relevant regulations, the proposal was never adopted. The initial proposal aims to ensure the redress for plaintiffs through reducing the burden of proof for plaintiffs. However, it should be noted that the effectiveness of this proposal needs to be further justified, because the transfer just ensures a reduction in the burden of proof for plaintiffs rather than increasing the possibility that plaintiffs prevail in lawsuits.

Pursuant to Article 35a (2), the Regulation 2013 finally did not reverse the burden of proof to CRAs. This provision requires plaintiffs to prove the infringement of CRAs by presenting accurate and detailed evidence, and the impact of the infringement on a credit rating outcome.[130] This burden of proof is more stringent for plaintiffs, especially for individual investors. It is almost impossible for individual investors to attain the necessary information as proof.[131] Even for institutional investors, this burden of proof is still hard to fulfil.

Apart from that, many terms listed in Article 35a(4), such as 'damage', 'intention', 'gross negligence', 'reasonably relied', 'due care', 'impact' and 'proportionate', have not been defined, and Article 35a(4) allows national laws and courts to define these core terms.[132] In this regard, on the one hand, the EU civil liability regime has a stringent fault standard. CRAs are held liable only if they have committed any infringement with intention or gross negligence, while mild, or even moderate, negligence does not meet the state of mind requirement. The ground is that credit rating is an assessment that includes complex economic factors during the rating process.[133] Applying various methodologies may achieve various results, none of which can be deemed as fault, even if they are insufficiently accurate or of a high quality.[134] On the other hand, EU legislators allows national courts to identify the boundaries of the civil liability regime. This may increase the uncertainty of the application of national laws.

d. Damage and Causation

The Regulation 2013 does not provide a specific definition of *damage*, and it grants this right to each member state to define and interpret damage and to apply it according to the national law. In practice, the obstacle regarding damage is to determine how much the damage is.

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130 Article 35a (2) of the Regulation 2013
131 Thomas M. J. Möllers and Charis Niedorf (n 43) 348.
132 Article 35a (4) of the Regulation 2013
133 Recital 33 in the preamble of the Regulation 2013
134 ibid

Even though there are some approaches to determining the damage, the harmonized one has been established at both the theoretical and practical stage so far. Two common methods of calculating damage claims include the (i) difference in market rate and (ii) reversal of investment decision.[135]

The causation presents in two stages: (i) the infringement has an actual impact on the rating and (ii) the impact leads to the damage. The causation itself seems reasonable but this requirement put a heavy burden of proof on plaintiffs. For the former requirement, as addressed above, the burden of proof is borne by the plaintiffs. An investor cannot access the necessary information to prove whether or not there is any infringement during the rating process. Most investors are also unable to know what kind of impacts there are on ratings outcomes.

In terms of causing damage, it also includes two things: first, the investor should prove that there is reasonable reliance on the affected rating. As discussed above, it seems a dilemma to prove the reasonable reliance and causation. In the absence of the definition of *reasonable reliance*, it is hard for plaintiffs to prove the reasonableness in practice. Second, an investor should prove the link between the credit rating and loss, that is, because of the reliance on the rating, the investor made such an investment decision whose financial instrument is rated by the same CRA.

6.3.2 The Lack of Harmonised Civil Liability Regime Through the European Union

[135] The former damages claim is based on the argument that a financial product was either purchased at an extremely expensive price or too low a price compared to a hypothetically correct price. Therefore, the damages claims should prove the reasonable difference between the actual price paid and the hypothetical correct price. In addition, it is also necessary to prove to what extent the impact of inaccurate credit rating on the actual price is. This is too difficult, because the market rate is driven by numerous economic factors instead of a single factor of credit rating. The latter damage claim is based on that reasonable reliance on a credit rating was the reason for the investment decision. Loss thus can be regarded as the result of reliance and is determined as the difference between the actual worth of the rated investment and the situation the investor never decided on the investment, namely negative interest. In addition to proof of reasonable reliance and causation, nvestors should prove that the investment preference of the investor was low risk. The financial instrument with inaccurate rating misled him into making such a decision. Thomas M. J. Möllers and Charis Niedorf (n 43) 349. The first resource seems Germen (Vasella, Haftung von Ratingagenturen, 2011, p. 370-2.; Barth, Schadensberechnung bei Haftung wegen fehlerhafter Kapitalmarktinformation, 2006, p. 195)

Article 35a of the Regulation 2013 allows the national courts to supplement and further constitute the civil liability regime in each member state,[136] which also leads to the concerns arising from the lack of a harmonized civil liability regime of CRAs in the European Union.

In Germany, even though there is no specific legislation governing civil liability of CRAs, an approach has been established to deal with the claimants without contractual relationships.[137] In the absence of contractual relationships, investors can claim damage against CRAs in tort under section 826 of the German Civil Code (Bürgerliches Gesetzbu).[138] This provision has high requirements in scienter, reliance and showing violation of public policy.[139]

In 2010, France adopted a specific law in relation to the civil liability of CRAs. Article L544-5 of the French Code *monétaire et financier* required CRAs to be liable for not only their client but also the third parties under both tort law and for their own violation of the Regulation 2009.[140]

Article 35a has been implemented in the UK legislation by the Credit Rating Agencies (Civil Liability) Regulations 2013.[141] This statutory instrument provides definitions for many terms. As mentioned before, the civil liability of CRAs could be established when there are contractual relationships, while in the absence of contractual relationships, the possible approach may be found in tort law. The two possible approaches need to be examined further. First, the tort of deceit requires the 'intention to cheat'.[142] For civil liability of CRAs, CRAs were held liable only when plaintiffs could prove that CRAs knew that their ratings were wrong or based on the wrong facts.[143] Second, in tort law, claimants could also hold CRAs liable on negligent misstatement claims. However, to prevail in a negligent

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136 Article 35a (5) of the Regulation 2013 provides that 'this provision does not exclude further civil liability claims in accordance with national law'.
137 Chiara Picciau, 'The Evolution of the Liability of Credit Rating Agencies in the United States and in the European Union: Regulation after the Crisis' (2018) vol 15(2) European Company and Financial Law Review, 393.
138 Brigatte Haar (n 106) 4-5.
139 ibid 5.
140 Article L 544–5, para 1, *Code monétaire et financier* states that '*Les agences de notation de crédit mentionnées à l'article L 544–4 engagent leur responsabilité délictuelle et quasi délictuelle, tant à l'égard de leurs clients que des tiers, des conséquences dommageables des fautes et manquements par elles commis dans la mise en œuvre des obligations définies dans le règlement* (CE) n° 1060/2009 du Parlement européen et du Conseil, du 16 septembre 2009, précité .' see in Chiara Picciau (n 136) 392.
141 The Credit Rating Agencies (Civil Liability) Regulations 2013 (2013 No 1637). This UK statutory instruments is the interpretation and complementation of Article 35a of the Regulation 2013.
142 *Nocton v. Ashburton* [1914] A.C. 932, 953. .
143 Thomas M. J. Möllers and Charis Niedorf (n 43) 356.

misrepresentation claim, claimants should prove the existence of the duty of care, the scienter that CRAs could foresee (and know) the trust of claimants in their ratings, and the proximity between the credit rating and the damage.[144]

As can be seen from the above, in torts of negligence, there is a different degree of standards in EU national courts. This implies that various national courts apply their own laws and thus may have inconsistent results. On this point, this may also give rise to difficulties in choosing national applicable laws and further regulatory arbitrage between EU member states. There is great uncertainty regarding which country's law should be applied, depending on many approaches: (i) the country where the issuer purchased the ratings; (ii) the country where the investors suffered the loss (given that the common damage in credit rating cases is pecuniary loss, it is difficult to identify the location of damage suffered); and (iii) the country in which the CRAs provided rating services.[145] In summary, the absence of harmonized civil liability regime for CRAs dilutes creditability and consistency of the EU civil liability regime.

6.3.3 Public Enforcement

Compared to the absence of a test in private enforcement, public enforcement has seen some progress. The interesting thing within the EU legal framework is that under Annex III[146], the same infringement can be regarded as the basis for not only civil liability, but also administrative liability. The Annex III was originally introduced by Regulation (EU) No. 513/2011[147] (hereafter 'Regulation 2011') and all the infringement listed in Annex III were originally designed to serve as the basis for regulatory power. Most of the infringements listed in Annex III under both Article 35a and Article 36 were also used to sustain civil liability claims since the Regulation 2013 introduced civil liability regimes.[148] In other words, not all the infringements listed in the Annex III could be the basis for civil liability, while all the listed infringements are used as the basis for administrative sanctions. As a result, when one CRA commits, intentionally or negligently, any infringement listed in

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[144] *Caparo Industries Plc v. Dickman (*1990) 2 AC 605, 610 margin no. B.; Thomas M. J. Möllers and Charis Niedorf (n 43) 356–7.
[145] Andrea Miglionico (n 44) 235.
[146] Annex III of the Regulation 2009
[147] Regulation No. 513/2011 of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies (OJ 2011 L 145).
[148] Articles 35a and 36 of the Regulation 2013

Annex III, European Securities and Markets Authority (hereafter 'ESMA'). [149] has the power to impose a fine on it. Compared to the elements under EU private civil litigation, one difference is that in public enforcement, ESMA can impose a fine only if there is simply negligence.

As can be seen from Table 6.1, in 2014, ESMA started to censuring the first CRA, namely S&P, with a public notice because S&P failed to meet some of the organizational requirements.[150] For the first public notice, ESMA spent more than two years on the investigation.[151] Between 2014 and 2020, there were 11 enforcement actions targeted at CRAs and ESMA fined six of them. Among all the existing monetary sanctions, the fine imposed on Fitch in 2019 is the biggest monetary penalty at a total amount of EUR 5.1325 million. To determine each fine for each infringement, ESMA spent approximately two years on investigations in the United Kingdom, Spain and France.[152] This could be seen as prudence of each enforcement decision for ESMA, especially as a recently established regulator. It also implies the difficulty for ESMA to investigate rating processes and collect evidence to prove any violation of internal rules or infringement, let alone the common investor.

In addition, according to the Table 6.1, ESMA has five public notices without monetary fines. Unlike the monetary sanction, the effect of public notice manifests in the consequent market responses. A public notice works via information diffusion and reputational mechanisms of markets.[153] Compared to the high number of fines, the public notice could be the supplement for administrative penalties, whose main benefit is to put an emphasis on the deterrence impact of enforcement actions and at the same time to dilute the negative impact on small investors by high fines.[154]

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[149] The Regualtion 2011 conferred ESMA centralized supervisory powers on credit rating agencies. Besides, Article 36(a) of the Regulation 2013 empowered ESMA to impose a monetary fine on credit rating agencies.

[150] ESMA, 'Public Notice' (2014) ESMA/2014/544 <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-544_-_decision_supervisory_measure_articles_23e_and_24_of_regulation_1060-2009.pdf> accessed 12 August 2020.

[151] Elizabeth Howell, 'The Evolution of ESMA and Direct Supervision: Are There Implications for EU Supervisory Governance' (2017) Volume 54, Issue 4 Common Market Law Review 1041.

[152] ESMA, 'Public Notice' (2019) ESMA41-356–22 <https://www.esma.europa.eu/sites/default/files/library/public_notices_fitch_group.pdf> accessed 2 September 2020.

[153] Dionysia Katelouzou and Konstantinos Sergakis, 'Shareholder Stewardship Enforcement' (ECGI Working Paper Series in Law, 2020) 11 <https://ecgi.global/working-paper/shareholder-stewardship-enforcement> accessed 10 October 2020.

[154] Proposal for a Regulation of The European Parliament and of the Council Amending Regulation (EC) No. 1060/2009 on credit rating agencies 2011 (COM(2011) 747 final 2011/0361 (COD)).

Table 6.1 An Overview of all ESMA Enforcement Actions for CRAs[155]

Name	Date	Breach	Fine (EUR)
1. Scope Ratings GmbH	4 June 2020	Breaches of the CRAs Regulation in relation to the systematic application of its 2015 Covered Bonds Methodology (CBM) and its revision.	640 000
2. Fitch Ratings Ltd. (UK). Fitch France S.A.S.; and Fitch Ratings Espana S.A.U.	28 March 2019	Between 2013 and 2015, issued four new ratings on instruments issued by a listed entity while a Fitch shareholder holding more than 10 per cent of its capital sat on the board of this entity; Failed to immediately assess the need to re-rate or withdraw ratings previously issued with regards to another entity, where a Fitch shareholder holding more than 10% of its capital sat on the board of this entity; Until March 2017, did not have in place adequate procedures with respect to conflicts of interest; Until March 2017, did not have in place internal control mechanisms designed to ensure compliance with its conflicts of interest obligations; Failed to disclose conflicts of interest regarding existing ratings of an entity, while a Fitch shareholder holding more than 10% of its capital sat on the board of this entity; Between 2013 and 2015, issued eight new ratings on instruments issued by a listed entity while a Fitch shareholder holding more than 10% of its capital sat on the board of this entity; and	5 132 500

[155] These actions in blue font are monetary fine cases and the others are public notices. Table adapted from ESMA, 'Enforcement Actions' <https://www.esma.europa.eu/supervision/enforcement/enforcement-actions> accessed 12 September 2020.

Name	Date	Breach	Fine (EUR)
		Failed to disclose that the existing ratings of the same listed entity were potentially impacted by the board membership of the Fitch shareholder holding more than 10 per cent of its capital.	
3. Svenska Handelsbanken AB (publ)	11 July 2019	Issuing credit ratings without being authorised by ESMA	No fine (public notice only)
4. Nordea Bank Abp (publ)	11 July 2019	Issuing credit ratings without being authorised by ESMA	No fine (public notice only)
5. Skandinaviska Enskilda Banken AB (publ)	11 July 2019	Issuing credit ratings without being authorised by ESMA	No fine (public notice only)
6. Swedbank AB (publ)	11 July 2019	Issuing credit ratings without being authorised by ESMA	No fine (public notice only)
7. Danske Bank A/S	23 July 2018	Issuing credit ratings without being authorised by ESMA	495 000
8. Moody's Deutschland GmbH; and Moody's Investors Service Ltd	1 June 2017	Ratings presentation Infringement; and Methodology disclosure infringement.	1 240 000
9. Fitch Ratings Limited	21 July 2016	Failed to allow the Republic of Slovenia 12 hours to consider and respond to the downgrade of its sovereign rating; No sound internal controls enabling it to comply with 'the 12-hour requirement'; and unauthorised disclosures of new and potential new sovereign ratings before that information was made public.	1 380 000
10. DBRS Ratings Limited	29 June 2015	Failed to meet the organizational requirements to establish adequate policies and procedures and to maintain	30 000

Name	Date	Breach	Fine (EUR)
		decision-making procedures and clear organisational structures; Failed to meet the requirements for an effective compliance function; and Failed to meet the requirements for adequate record keeping.	
11. Standard & Poor's Credit Market Services Europe Limited; and Standard & Poor's Credit Market Services France SAS	3 June 2014	Failed to meet the organizational requirements when erroneously suggesting a downgrade of the Republic of France.	No Fine (only Public Notice)

In short, the advantages of EU public enforcements include: first, the public enforcer, such as ESMA, has better investigative power to obtain the internal information during rating process than an individual claimer in civil litigation. Considering the burden of proof on the plaintiffs under Article 36(a), effective administrative sanctions are able to better improve the intrinsic limitations within the private civil liability regime; second, the enforcement actions by ESMA is harmonised and consistent through the European Union, which also avoids potential conflicts arising from the application of national laws and the consequent regulatory arbitrages; third, the administrative monetary penalties and sanctions (such as a public notice) have a significant deterrent effect in preventing potential misconduct in the credit rating industry. However, ESMA administrative enforcements have so far been limited in number. One major reason is that ESMA was recently established and regulatory resources are, to some extent, limited. For instance, ESMA distributed 32 members of staff (132 staff in total) to one S&P investigation in 2013,[156] which indicates that one investigation, merely as a part of an enforcement action, already occupied one fourth of ESMA's human resources. Another ESMA report supports this argument: 'approximately 35% of staff time was engaged in thematic and individual investigations; 25% in single rulebook and international cooperation; and 10% in registration/perimeter and risk analysis-related

[156] Elizabeth Howell (n 151).

activities (totalling 90% of staff time)'.[157] Although the deficiency of the ESMA supervision seems evident, public enforcement appears as a more efficient remedy against credit rating misconduct.

To sum up, public enforcements play a greater role in deterring CRAs, especially when the civil liability of CRAs cannot be established. As discussed earlier in this section, these EU enforcement attempts (including administrative enforcements and private litigation) suggest a trend of a dual-track approach that combines public and private enforcement. It should be noted that the enforcement by ESMA is *ex post* enforcement action and cannot replace the role of private enforcement in reinstitution and deterrence to CRAs. It is also notable that all the ESMA enforcement actions are based on the compliance of organization or rating process rather than the liability for inaccurate rating, which further supports the fact that public enforcement plays a more important role in practice than private enforcement.

6.3.4 Critical Assessment

First, the EU civil liability regime is designed to provide redress for investors and issuers without contractual relationships, but it has some obstacles for claimants. Under the EU civil liability regime, many key terms contained in elements are not clearly defined. In addition, causation and reasonable reliance make it difficult to satisfy plaintiffs. The burden of proof rests entirely with investors, which further increased the difficulties to prevail the claim.

Second, the civil liability regime lacks a harmonized standard across the EU member states. For one thing, judicial result of a relevant credit rating case under Article 35a may depend on various national courts. For another, this may also give rise to regulatory arbitrage in possible member states. This uncertainty of the application of national laws may dilute the credibility of the civil liability regime.

Third, public enforcement could be regarded as an optimal remedy to deter credit rating misconduct, while private litigation focuses more on restitution. As MacNeil observed, 'the emphasis on *ex ante* prevention of systemic risk means that *ex post* enforcement action cannot play a major role in prudential supervision because by that time the regulator will have failed to secure the regulatory objective' and 'private enforcement is often available as

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157 ESMA, 'Report on Staffing and Resources' (2014) ESMA/2014/939 <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-939_report_on_staffing_and_resources_related_to_cra_supervision.pdf> accessed 10 September 2020.

a supplement to or substitute for the public enforcement'.[158] The EU civil liability regime was originally designed to supplement public enforcement or constitute a dual-track legal framework, combining public and private enforcements. Nevertheless, with few relevant cases arising after the establishment of the EU civil liability regime, the effectiveness of the EU civil liability regime remains to be seen in future. In contrast, public enforcement appears more efficient and effective.

There are some similarities between the European Union and the United States. First, like the United States, the European Union has a similar motivation to rebuild the market confidence in CRAs and the financial market after the financial crisis. Therefore, in order to deter CRAs, both the European Union and United States apply the same regulatory strategy: imposing a threat of holding CRAs liable may make CRAs behave well. The rationale behind this is that according to the least-cost avoider principle, the party who is more likely to avoid harm at less cost should have a liability imposed on it.[159] Between a CRA and an investor, a CRA is more capable of obtaining more public and private information from its frequent clients (issuers), and to better analyse and assess such information based on its expertise. Unlike a CRA, most investors cannot have the information and expertise. The cost investors pay to avoid harm arising from negligence is much more than that CRAs do as a whole. In other words, a CRA that is able to better avoid the harm caused by negligence should have a liability imposed on it. In this regard, both the European Union and United States thus enhanced the civil liability regime for CRAs as a supplement to the regulatory framework.

Second, it has been observed that claimants are unlikely to establish civil liability of CRAs through private litigation in both European Union and United States; on the contrary, public enforcement appears more progresses. The major reason is that the plaintiffs face very demanding pleading standards in private litigation. The impediments are the high-level burden of proof imposed on claimants and limited capability of access to internal information for claimants. Before these difficulties can be solved or mitigated, private enforcement remains ineffective in deterring rating misconducts. This also explains that along with the establishment of civil liability, both the European Union and United States carry out some public enforcement actions. The future enforcement regarding CRAs may attach more importance to public enforcement, as well as private enforcement as a supplementary support.

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[158] Iain MacNeil, 'Enforcement and Sanctioning' in Niamh Moloney, Eilìs Ferran and Jennifer Payne (ed), The Oxford Handbook of Financial Regulation (Oxford University Press 2015) 293, 298.
[159] Husisian (n 39).

6.4 China

6.4.1 The Civil Liability Regime

Before analysing the civil liability of CRAs, it should be noted that the most important characteristic of China's legal system is that it is based on statute law rather than cases. Therefore, in general, the assessment a civil liability regime of CRAs should stem from each statutory law. Even though there are a few relevant statutory laws regarding the civil liability of CRAs, these can still constitute a civil liability regime for redress in theory. In general, where there is a contract between a CRA and the other party, such as an investor or issuer, the dispute can be solved in accordance with contract law; while in the absence of a contractual relationship, whether or not an investor or issuer can still claim for damage becomes the question. It should be noted that Chinese contract law does not have express protection for the third-party beneficiary. Even though there is no specific legislation governing the civil liability of CRAs, several provisions of securities laws and the general rules of tort law will apply to the CRA civil liability.

According to Article 169 of the Securities Law of China, CRAs can be regarded as securities trading service organizations, like other professional securities investment consulting organizations.[160] Also, Article 170 provides the requirements of rating analysts within CRAs.[161] These provisions granted a role of professional financial intermediary to a CRAs. More importantly, Article 173 specifies the civil liability for CRAs in theory.[162] These

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[160] Article 169 the Securities Law of China provides that 'where an investment consulting institution, financial advising institutions, credit rating institutions, asset appraisal institutions, or accounting firm engages in any securities trading service, it shall be subject to the approval of the securities regulatory authority under the State Council and the relevant administrative departments. The measures for the administration of examination and approval of the practice of securities trading services by the investment consulting institutions, financial advising institutions, credit rating institutions, asset appraisal institutions and accounting firms shall be formulated by the securities regulatory authority under the State Council and the relevant administrative departments.'

[161] Article 170 the Securities Law of China provides that 'the staff of an investment consulting institution, financial advising institutions or credit rating institutions who engage in securities trading services shall have the special knowledge of securities as well as work experience in the securities business or securities trading services for more than 2 years. The standards for recognizing the securities practice qualification and the measures for administration thereof shall be formulated by the securities regulatory authority under State Council.'

[162] Article 173 the Securities Law of China states that 'where a securities trading service institution formulates and issues any auditing report, asset appraisal report, financial advising report, credit rating report or legal opinions for the issuance, listing and trading of securities, it shall be assiduous and dutiful by carrying out examination and verification for the authenticity, accuracy and integrity of the contents of the documents applied as the base. In the case of any false record, misleading statement or major omission in the documents it has formulated or issued, which incurs any loss to any other person, the relevant securities trading service institution shall bear several and joint liabilities together with the relevant issuer and listed company, unless a securities trading service institutions has the ability to prove its faultlessness.'

provisions in essence constitute civil liability of CRAs. Under the Chinese civil legal system, the mainstream idea is that the expert liability of CRAs should be based on tort law principles.[163] According to the rationale of Chinese tort law, each element of expert liability, namely infringed conduct, damage, causation and fault will be discussed.[164]

a. Infringed Conduct

First of all, Article 173 introduces expert liability and the relevant civil liability of CRAs. A CRA should be 'assiduous and dutiful' for the 'authenticity, accuracy and integrity' of its statements that are used for insurance of securities. Based on this, a CRA is held liable when it issues a false, misleading statement or major omission. The harm conduct involves issuing the aforementioned. However, the China Securities Act has not provided specific standards to further determine these conducts for CRAs, such as the definition of *false record*, *misleading statement*, *major omission*, *infringed party* and so on.

In the absence of contractual relationships, an investor or issuer could claim for damage under Article 173, because an infringed party involves 'any other person'.[165] Thus, the question is how to determine the scope of 'any other person'. So far, few researchers have addressed this question definitively, and there is no defined scope.[166] However, combining the words in the same sentence, namely 'the relevant issuer and listed company', could imply that the 'any other person' here does not include an issuer but an investor. Even though there is no conclusion, at least Article 173 is initially designed to provide redress for investors.

In terms of false record, misleading statement and major omission, Article 17 of 'Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market' (hereafter 'Civil Compensation Arising from

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[163] Mei Yang [杨梅] and Suzhi Wang [王肃之], 'On The Theory and Legislation About Third Party Tort Liability of Experts [专家对第三人侵权责任的理论与立法思考]' [2014] Journal of Heilongjiang Administrative Cadre Institute of Politics and Law [黑龙江省政法管理干部学院学报] 82.; see also Wenyu Liu [刘文宇], 'Research of Civil Responsibility of Credit Rating Agency [信用评级机构民事法律责任研究]' (PhD Thesis, University of Jilin 2013).

[164] Xinbao Zhang [张新宝], *Tort Liability Law[侵权责任法]* (China Renmin University Press [中国人民大学出版社] 2016) 23-34.

[165] Article 173 of the Securities Law of China.

[166] Regarding this definition of 'any other person', there is no relevant discussion, see Xiao Cheng [程啸], Tort Liability Law [侵权责任法] (Law Press [法律出版社] 2008) 208; Jinqing Zhu [朱锦清], Securities Law 证券法学 (Peking University Press [北京大学出版社] 2016) 141.

False Statement')[167] provides a reference standard to determine the false record, misleading statement and omission. The first thing is that the contents of a false record, misleading statement and omission should be the important issue, which means having an impact on issuing or trading securities. The second thing is that the false record and misleading statement could be proven false. For the former standard, the credit ratings have a significant impact on securities issuing and trading, and they could thus be deemed as important issues. Nevertheless, for the latter, it is difficult to prove whether or not the credit rating outcome is accurate, because a credit rating is a financial prediction, as discussed in the United States and European Union sections above. In addition, using different methodologies may lead to various ratings outcomes, but there is no uniformly accurate methodology; in other words, it remains uncertain how to determine the existence of a false record, misleading statement and omission.

b. Damage

As Zhang provides, the damage is an adverse result of person and property under Chinese tort law.[168] The property damage includes destruction of property, economic loss and so on.[169]. Under Articles 30 and 33 of the Civil Compensation Arising from False Statement,[170] the scope of compensation for damage should be determined by the actual loss, and the

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[167] Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market [最高人民法院关于审理证券市场因虚假陈述引发的民事赔偿案件的若干规定] 2003 (Interpretation No. 2 [2003] of the Supreme People's Court).

[168] Xinbao Zhang [张新宝] (n 163) 27.

[169] ibid.

[170] Article 30 of the Civil Compensation Arising from False Statement provides that 'the scope of liability of a person disseminating false statements in the securities market is determined by the actual loss suffered by the investors from relying on the false statements. Actual losses that can be suffered by investors include:
(1) Loss from caused by the difference in investment capital.
(2) Commission and duties caused by the difference in investment capital.
The interest referred to above shall be calculated from the date of purchase to the date of sale of the securities in accordance with the bank's savings account interest rate for the respective period in question.'
Article 33 provides that 'the term "base date" for the purpose of calculating the difference in capital refers to the deadline set down within a reasonable period of time after the false statement is disclosed or corrected, so as to calculate the scope of losses suffered by investors as a result of the false statements. The base date shall be determined according to the following:
(1) From the disclosure or correction date to the date when the volume of the shares affected by the false statement achieve 100%. However, the volume of shares transferred through major deals shall not be included in this calculation.
(2) If it is not possible to determine a base date in accordance with Clause (1) prior to the court hearing, then the base date shall be 30 transaction days after the disclosure or correction date.
(3) For shares already withdrawn from the securities market, the base date shall be one transaction day prior to the date the shares are withdrawn from the securities market.
(4) For shares which have already ceased trading in the securities market, the base date shall be one transaction day prior to the date the shares have ceased being traded in the securities market; where trading has resumed, the base date shall be determined in accordance with Clause (1).'

damage can be calculated by the difference in investment capital within a reasonable period, such as from the date of purchase to the date of sale of the securities. In this regard, a plaintiff is able to claim for compensation based on these provisions.

c. Causation and Reliance

In terms of causation, China has a single requirement of a causal connection between the conduct by a defendant and the loss suffered by a plaintiff. Article 173 implies that a plaintiff should prove the damage he suffered is caused by the infringed conduct by a CRA, but this provision lacks specific explanation. Some researchers argue that Article 18[171] and Article 19[172] of the Civil Compensation Arising from False Statement provide specific standards to determine the causation between the securities transaction made by investors and infringed conduct by defendants.[173] Nevertheless, whether the two provisions can be regarded as a part of the civil liability regime of CRAs remains uncertain.

For credit rating cases, Article 18 requires that (a) the financial instrument invested by an investor should be rated by a CRA; and (b) the investor should prove that it suffered the loss during its purchase of the financial instrument 'on or after the date the false statement disseminated and before the disclosure or correction date and selling or holding the financial instrument after the disclosure or correction date.' Article 19 provides specific defences for a defendant to invalidate the proof of causation; in other words, the two provisions constitute a rebuttable presumption of reliance.

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[171] Article 18 of the Civil Compensation Arising from False Statement provides that 'when the investor satisfies any of the following conditions, the People's court should make a judgment that there is causality between the false statement and the losses of investor.
(1) The securities, in which the investor invested, have a direct relationship with the false statement
(2) The investor purchased the securities on or after the date the false statement was disseminated and before the disclosure or correction date.
(3) The investor suffered losses because of selling or holding the securities after the disclosure or correction date.'

[172] Article 19 of the Civil Compensation Arising from False Statement provides that 'if the defendant can present the evidence to prove that the plaintiff satisfies any of the following conditions, the People's Court should make a judgment that there is no causality between the false statement and the losses of investor.
(1) The investor sold the securities before the disclosure or correction date.
(2) The investor purchased the securities after the disclosure or correction date
(3) The investor purchased the securities knowing about the false statement.
(4) The losses or partial losses were caused by systematic risks related to the stock market.
(5) The investor acted in bad faith or intended to manipulate the prices of securities.'

[173] Tian Yu [田彧], 'The Study on The Legal Issues of Civil Liability of Credit Rating Agencies [信用评级机构民事责任法律问题研究]' (Master Dissertation, China University of Political Science and Law [中国政法大学] 2018) 79-80.

Zhu argues that Articles 18 and 19 resemble the US fraud-on-the-market theory in many respects.[174] The application of fraud-on-the-market aims to reduce the burden of proof on plaintiffs. However, as addressed in the reliance element of the US section, whether the fraud-on-the market theory has or does not have an effect on reducing the burden of proof for plaintiffs seems still in doubt. Apart from that, one of the assumptions of the fraud-on-the-market theory is that the market is public and efficient, and the price of traded stock is determined by all the available information regarding companies and businesses, whether true or false.[175] In this regard, there is no need to identify the reliance of investors on that information, because the information, whether true or not, was incorporated into, and reflected in, the market price. Back to China, it still remains uncertain whether the Chinese stock market is or is not an efficient market, let alone the bond market.

Like the United States, even though some researchers argue that Articles 18 and 19 could be deemed as presumption of reliance in relation to CRAs cases, several necessary preconditions were not justified. They neither affirm that the Chinese bond market is sufficiently efficient, nor justify whether the adoption of the fraud-on-the-market doctrine contributes to decreasing the burden of proof for plaintiffs. In short, the current Chinese civil liability regime appears vague, especially when it comes to causation and reliance.

d. Fault standard

In terms of the fault standard, under tort law, the burden of proof is generally borne by the claimant. In contrast, for the relevant cases against CRAs, Article 173 of the Securities law of China reverses the burden of proof to the defendant. Unless CRAs can prove they are not at fault, otherwise, they should bear the relevant liabilities. This implies that the state of mind for CRAs is assumed as fault before CRAs prove lack thereof. Compared to the strict requirement of state of mind in the European Union (gross negligence) and the United States (scienter), China, to a large extent, has lessened the burden for state of mind.

It should be noted that the reason why the Chinese civil liability regime has the lower burden of proof on a claimant is the pretrial procedure, as it will be discussed in the next section. According to the pretrial procedure, the court accepts the lawsuit only when the claimants has provided the penalty decision issued by the relevant regulators, as will be addressed in

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[174] Jinqing Zhu [朱锦清] (n 165) 154. See also Tian Yu [田彧] (n 173).
[175] *Peil v. Speiser,* (n 65) 1160.

detail in the next section. In short, the administrative penalty decision has a parallel impact on the civil litigation. The penalty decision is the important supplementary evidence to support the causation. Thus, the civil liability regime puts lower burden on the fault standard.

Having demonstrated all the elements of Chinese civil liability for CRAs, the current civil law framework is too concise to establish civil liability of CRAs. The concise description aims to avoid mitigating the protection scope, but its disadvantage is obvious that the vague and broad expression creates difficulties for the application. Owing to the lack of a specific legislation or provisions, the Chinese civil liability regime has intrinsic limitations. In a nutshell, it is difficult for claimant to hold CRAs liable in the absence of contractual relationships.

6.4.2 Pretrial Procedure

Besides the intrinsic limitations of the Chinese civil liability regime, in practice, it is nearly impossible for investors to prevail the lawsuits against CRAs. So far, only a limited number of civil actions of false statement have been allowed to be brought to court. Among these cases, none is associated with the CRAs. The major shield against the Chinese civil liability regime is the pretrial procedure in litigation.

In 2002, the Supreme Count enacted 'Notice of the Supreme People's Court on the Relevant Issues Concerning the Acceptance of Cases of Disputes over Civil Tort Arising from False Statement in the Securities Market' (hereafter '2002 Notice of False Statement').[176] Article 2[177] established a requirement of pretrial procedure in civil actions arising from false statement. This requires an investor who attempts to bring a lawsuit against a CRA under securities law to obtain the official document with a penalty decision issued by the CSRC and its affiliates first. Otherwise, investors are not allowed to bring a lawsuit to court directly. This pretrial requirement of litigation, to a large, extent blocked the channel for all cases associated with CRAs.

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[176] Notice of the Supreme People's Court on the Relevant Issues Concerning the Acceptance of Cases of Disputes Over Civil Tort Arising from False Statement in the Securities Market[最高人民法院关于受理证券市场因虚假陈述引发的民事侵权纠纷案件有关问题的通知] (No.43 [2001] of Supreme People's Court（法明传[2001]43 号）).

[177] (Own translation) Article 2 of the 2002 Notice of the False Statement provides that 'in the case of civil compensation for false statements accepted by the people's court, the possible conduct of false statement must be investigated by the China Securities Regulatory Commission and its dispatched agency, and be affirmed as conduct of false statement with an effective penalty decision. If the party relies on the investigation result as the factual basis for filing a civil lawsuit, the people's court should accept it according to the law.'

In order to understand the rationale for this pretrial procedure, the background of the 2002 Notice of False Statement should be sketched. In China, the first-edition securities law did not go into effect until 1999.[178] The first civil action of false statement related to securities was brought in 2001.[179] At that stage, few courts had expertise and experience to deal with such relevant cases. In this regard, the 2002 Notice of False Statement was designed to cope with the following cases of false statement, but, at the same time, the pretrial procedure was created to avoid a large number of cases being brought to court. Therefore, as the Supreme Court explained, the rationale behind the pretrial procedure was that without the pretrial procedure in private securities litigation, the number of cases might be excessive, and the court was unable to effectively and technically deal with numerous lawsuits of false statement in the securities market.[180]

On the one hand, the courts had insufficient capability and expertise to deal with numerous litigations of false statement. The normal concern is that without the pretrial procedure, the number of relevant cases would increase rapidly. If the courts insisted on dealing with relevant overloaded litigation, it may lead to uneven allocation of judicial resources. More importantly, the improper judicial response to each civil action may have a negative influence on the stability of the securities market. Apart from that, the pretrial procedure requires plaintiffs to access official documents with a penalty decision issued by relevant regulators, which contributes to reducing the burden of proof on plaintiffs. The document issued by the relevant regulators can be regarded as the most appropriate evidence. Compared to courts, the relevant regulators have more expertise and experience in financial markets, and they are more capable of collecting and processing relevant information and issuing a professional judgment.

On the other hand, the pretrial procedure shields claimants from bringing actions to the courts. These blocked actions include not only credit rating lawsuits, but also a large number

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178 Securities Law of the People's Republic of China (1998). See Xinhua News Agency [新华社], 'China Enacted the Securities Law at the First Time [中国颁布第一部证券法]' Beijing Evening News [北京晚报] (29 December 1998) <http://news.sina.com.cn/richtalk/news/money/9812/122903.html> accessed 20 August 2020.

179 The first case is Yinguangxia(or Guangxia Yin Corp.) [银广夏事件] Yaoyao Chang[常瑶瑶], 'Research on Prepositional Procedure of Civil Litigation [民事诉讼前置程序研究]' (Master's Dissertation, Southwest University of Political Science and Law [西南政法大学] 2016, 22).

180 Guoguang Li [李国光], The Supreme People's Court's Understanding and Application of Judicial Interpretations on Trial of Cases of False Statements in the Securities Market [最高人民法院关于审理证券市场虚假陈述案件司法解释的理解与适用] (People's Court Press [人民法院出版社] 2015) 24-8.

of false statement lawsuits. The pretrial procedure was originally created to prevent floodgate effects of lawsuits, based on the fact that the judges had insufficient experience and expertise to deal with such cases. Given the background of the enactment of the 2002 Notice of False Statement, the pretrial procedure was, to some extent, reasonable during a particular period. Nevertheless, three decades later, the pretrial procedure still remains, and the legislator has not shown any intention to abolish it. One possible reason is that legislators lack an incentive to abolish it because they are more inclined to ensure the efficiency of the securities market rather than investors' protection, which is similar to the freedom of speech as a shield against plaintiffs in the United States.

6.4.3 Administrative Approach

In terms of public enforcement, there is only one administrative punishment on Dagong so far. In 2018, the CSRC[181] suspended Dagong securities business for one year.[182] The investigation by the CSRC states: (1) Dagong failed to adhere to its internal corporate codes; (2) Dagong sold additional services at an overly high price to its clients who already purchased its rating services; (3) some of their rating analysts and senior managers were not qualified in accordance with relevant laws; and (4) material omissions and deficiencies existed in rating data of manuscripts as well as its rating model.[183] Besides suspension, the CSRC did not impose any other penalty on Dagong. Compared to the administrative enforcements in the United States and European Union, the degree of sanction in China seems mild.

As discussed in the section of the pretrial procedure, the court transferred the problem to the regulator, thus why is there only one administrative punishment? One possible explanation is that the pretrial procedure is designed not just for credit rating cases, but all the securities cases arising from false statement. Like the situation in the United States and European Union, prior to the financial crisis of 2007–8, CRAs are evidently not the regulatory focus in China.

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[181] One of main governmental regulators in China [中国证监会]

[182] Dagong's misbehavior violated the relevant regulation and rules under Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market[证券市场资信评级业务管理暂行办法] (No 50 [2007] of China Securities Regulatory Commission [证监发[2007] 50 号]). See CSRC, 'CSRC Suspended Dagong Securities Rating Business for One Year [证监会暂停大公国际证券评级业务一年]' (2018) <http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201808/t20180817_342750.html> accessed 22 February 2019.

[183] CSRC (n 182).

Until 2019, the four main regulators[184] enacted the Interim Measures for the Administration of the Credit Rating Industry (hereafter 'Interim Measures'). [185] Compared to the two previous laws,[186] the most significant change brought about by the Interim Measures is that the administrative penalties have been strengthened to a large extent. The whole of Chapter 8 (from Article 53 to Article 63) provides a set of sanctions associated with various violations, ranging from a public notice to a monetary penalty. In great detail, pursuant to Article 63, an official website (Credit China)[187] was specially designed to disclose all the public warnings and punishment notices with regard to CRAs. In addition, the Interim Measures raised the level of penalties. The amount of monetary penalty increased dramatically, with the maximum fine from 0.3 million yuan (nearly equal to USD 45 thousand) before[188] to 5 million yuan (nearly equal USD 0.75 million)[189] Looking back to the case of Dagong, as mentioned above, this also explains why the penalty in that case is far less severe than the administrative penalties in the United States and European Union, because the regulator did not have such wide-ranging power to punish CRAs with misconduct until the enactment of the Interim Measures. In summary, CRAs did not come into regulatory sight and became regulatory focus until recently. Additionally, China attaches more importance to public enforcement rather than private liability regime in deterring CRA misconducts.

6.4.4 Critical Assessment

There are some similarities and differences in the European Union, United States and China. First, the motivation to establish civil liability of CRAs bear resemblances. The United States, European Union and China seek to rebuild market confidence through enabling CRAs to be held liable for their misconduct. There is a contingency that CRAs become the regulatory focus. The reason why CRAs were chosen to be the regulatory or legislative focus is that CRAs played a significant role in the financial crisis and thus come into public sight. After

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[184] People's Bank of China, the National Development and Reform Commission, the Ministry of Finance and the China Securities Regulatory Commission

[185] Interim Measures for the Administration of the Credit Rating Industry [信用评级业管理暂行办法] 2019 (No. 5 [2019] of People's Bank of China, the National Development and Reform Commission, the Ministry of Finance and the China Securities Regulatory Commission).

[186] The two previous laws are Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market[证券市场资信评级业务管理暂行办法] and Guiding Opinions of the People's Bank of China for the Management of Credit Rating [中国人民银行信用评级管理指导意见] (No 95 [2006] of the People's Bank of China [银发[2006]95 号]).

[187] Credit China [信用中国], 'Credit China' <https://www.creditchina.gov.cn/home/index.html> accessed 10 October 2020.

[188] Article 202 of the Securities Law of China

[189] See in Article 55, 57, 58, 60 and 61 of Interim Measures for the Administration of the Credit Rating Industry [信用评级业管理暂行办法].

the financial crisis, the United States and European Union have more active incentives to rebuild financial confidence and they thus take more measures to pursue this objective. However, this regulatory attention may be temporary and contingent.

By contrast, the first difference in the three areas is the varying degree of the incentives. Both in the United States and European Union, the establishment of civil liability is directly motivated by the financial crisis of 2007. For CRAs, the financial crisis yielded at least two lessons: (i) the systemic risk of the whole financial market was aggravated by CRAs[190] and (ii) the failure of reputation mechanism in the credit rating industry added to this, [191] as addressed in the previous chapters. However, China did not learn the lessons from the financial crisis as soon as the European Union and United States did. The financial crisis had a comparatively moderate influence on the Chinese financial market. As a result, in contrast to the United States and European Union, China did not make CRAs its regulatory focus immediately.

Aside from that, unlike the United States, the Chinese market of the structured finance is comparatively limited in scale and transaction amounts. Furthermore, in 2012, the Chinese regulator further required that the structure of credit asset securitisation products should be simple and clear, and therefore, the re-securitisation or synthetic securitisation in the expanded pilot stage would not be allowed.[192] Unlike the European Union, China had not experienced the sovereign rating crisis. The stage of Chinese CRAs maybe remains that between unregulated and highlighting regulated stage. With the bonds market enlarging, even though China realised the important role of CRAs in financial stability, it still lacks one direct motivation to establish the civil liability of CRAs to rebuild market confidence.

Second, the insurmountable obstacles within each civil liability regime bear a resemblance. The United States, European Union and China explored several possible approaches to establish civil liability for CRAs in the absence of contractual relationships. The major obstacles within each civil liability regime are similar, such as the state of mind, reasonable reliance and causation.

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190 As addressed in the section 3.4 of Chapter

191 As addressed in the section 4.4.1 of Chapter 4 and section 5.3.3 of Chapter 5

192 People's Bank of China, Ministry of Finance, and China Banking Regulatory Commission, 'Notice of the People's Bank of China, the China Banking Regulatory Commission and the Ministry of Finance on Relevant Matters Concerning Further Expanding the Pilot Securitization of Credit Assets [中国人民银行、中国银行业监督管理委员会、财政部关于进一步扩大信贷资产证券化试点有关事项的通知]' (2012) No. 127 [2012] of the People's Bank of China (银发[2012]127 号）.

On the contrary, the three regions are faced with different forms of resistance. When the United States attempted to establish expert liability arising from the false registration statement against CRAs, it faced market resistance and the expert liability attempt finally stalled. The European Union has to deal with the inconsistent application of laws in each member state. In China, the primary obstacle is the pretrial procedure, while from an in-depth perspective, the internal limits of legal structures demotivate courts and regulators from dealing with the CRA issue.

As discussed above, one possible explanation for the long-term existence of the pretrial procedure is that legislators do not have an incentive to repeal or replace it. For one thing, the pretrial procedure creates information asymmetry between the potential claimants and courts, and this institutional deficiency further hinders the courts from realising the real demand for credit rating actions. Unlike the common law system, Chinese civil liability cannot be enriched by each case. In a civil law country, when potential claimants find that some obstacles within the litigation are too difficult to overcome, they do not have sufficient incentives to bring actions to the court. Furthermore, this has a negative effect on the future reform of CRAs, because the pretrial procedure, in reverse, reduces the opportunities for courts to deal with the cases, and small numbers of relevant actions may mislead the supreme court in accurately assessing the importance of the issue.[193] This explains, from another point of view, why there has been no civil action with regard to credit ratings so far.

At last, as has already been examined, the recent legal attempts against credit rating misconduct through the establishment of a civil liability regime in the European Union, United States and China, make it apparent that public enforcements are more effective means than private enforcement. This chapter does not highlight the greater role of public enforcement, but tries to compare the effectiveness between the public and private enforcement. Is civil liability a solution? Before answering this question, it is noted against which background these regulations were proposed. After reviewing the financial crisis and the role of CRAs in the 2007–8 financial crisis, the US and EU regulators have put in place measures to reduce the regulatory over-reliance, to manage conflicts of interest and improve market competence.[194] In order to achieve the common regulatory objectives, namely make the CRAs behave well and rebuild market confidence, the CRA civil liability regime was

[193] The supreme court will issue relevant judicial interpretation as a supplement annually once a particular class of cases are accumulated to a certain amount.
[194] As addressed in Chapters 3,4 and 5.

proposed to supplement these regulations. In this regard, the CRAs' civil liability regime has not achieved its anticipated goal. From the perspective of curbing CRAs misconduct, public enforcement appears to be a better strategy. For one thing, compared to the private law remedies, the public enforcement is more practicable and effective, which could be seen from the comparison between the cases of administrative punishments and civil lawsuits. Few plaintiffs successfully established the civil liability for CRAs in civil claims, while the CRAs were more frequently punished by the public enforcement. For another, the cost, namely damage compensation and reputation loss, that CRAs suffered, when they lose lawsuits of the civil liability, is less than that they suffered in the public enforcement, such as censure, public notice and monetary penalty. In other words, the public enforcement can more effectively deter CRAs from conducting misbehaviours.

Chapter 7: Conclusion

This thesis analysed the issues that resulted in the big rating failure during the 2007–8 financial crisis from both an external and internal perspective. From the external perspective, the market and regulatory over-reliance on credit ratings strengthened the impacts of rating downgrades so that these downgrades resulted in a cascade of negative effects on the financial system. Chapter 3 explained that the over-reliance exacerbated the liquidity risk, as well as the systemic risk, stemming from the rating downgrades, especially during the financial crisis. From an internal perspective, the inaccuracy of credit ratings constitutes another reason for the rating failure. As seen in Chapters 4 to 6, the three issues negatively affected the credit rating quality, namely (i) conflicts of interest, (ii) the oligopolistic market structure and (iii) the civil liability for CRAs. Chapter 4 addressed the fact that CRAs are motivated by huge profits from the rating businesses on structured finance, regardless of their capability and rating quality. In Chapter 5, it is observed that under an oligopolistic market, the big three usually lack the necessary deterrence to ensure their rating quality. Chapter 6 addressed the weakness of the civil liability regime for CRAs in the European Union, United States and China in effectively deterring CRAs for their rating quality. In short, the four issues in this thesis address the external and internal grounds of the rating failure.

As seen above, the legal and regulatory developments are in parallel with the actual market demand in each region. Thus, when comparing the different regulatory approaches in the European Union, United States and China, the underlying demand should be considered first. Chapter 2 provided the three differing social contexts of the European Union, United States and China. It is observed that under each social context, regulating CRAs faced with similar but varying degrees of impediments. All the existing regulatory regimes for CRAs are reasonable but not effective enough. For one thing, the reasonability manifests in two regards: (i) these regulatory approaches are targeted to existing problems; and (ii) the regulatory approaches fit, to some extent, the flexible demand for regulators. For another, the implementations seem less effective than expected. This thesis aimed to find a path to making CRAs behave well by discussing key issues related to the rating failure in detail. Based on the existing reforms related to CRAs, this thesis provided some supplementary suggestions on how to improve current issues. The rating failure has been caused by many factors for a long time. To achieve the improvement of CRAs, innovative and thorough solutions considering all the factors mentioned should be thought of and be implemented long into the future.

In Chapter 2, having illustrated the evolution of CRAs and the relevant regulatory systems in the European Union, United States and China, the comparative and retrospective study assists with the analysis of the main CRA issues and the three regions' various regulatory approaches in chapters that follow. It should be noted that the varying degrees of development trajectories lead to different problems and provide various incentives for the three regions to regulate CRAs. In the United States, the regulatory licence, namely the NRSROs, played an important role in the development of CRAs, because the approval of NRSROs offered special market status to recognised CRAs. Since the approval of NRSROs, the credit ratings issued by them have increasingly been employed int legislation, regulations and standards. This contributed to the over-reliance on credit ratings in the United States. Given the huge impact of the eurozone crisis, the European Union has the political motivation to deal with issues related to CRA. Compared to the global financial crisis of 2007–8, the subsequent euro area crisis raised more significant concerns for the EU member states about the over-reliance on the external or foreign CRAs. The Chinese multi-regulator system, to some extent, held back the development of CRAs during a certain period. China has fewer unsolved problems or less severe problems than those faced by the other two regions.

Furthermore, the backgrounds sketched assisted with a better understanding of the differences in the main issues and regulatory approaches in these regions in the chapters that followed. In addition, to the over-reliance on ratings provided by NRSROs, for a long time the approvals of NRSROs were merely offered to the big three in the United States, which, from a historical perspective, explains the oligopolistic market structure of the big three in the US market. With the development of economic globalization in the European Union, the big three gradually occupy global market share, especially in the European market. At that time, the Chinese bond market was not yet formed. This also explains why the EU market was occupied by the big three, while the Chinese market seems moderately concentrated. Apart from that, it seems obvious from the EU regulations for CRA set out in the chapters that the European Union has political motivations. It is also observed that the Chinese regime of CRAs seems over-concise, as the demand for regulation of CRAs is less than in other two areas.

Chapter 3 points out that the wide uses of credit ratings in legislation, regulation, standards and political standards are the root of over-reliance on CRAs. More importantly, the negative impacts of the over-reliance on credit rating address the need to reduce this over-reliance. The existing regulations in the European Union, United States and China against over-reliance have achieved a certain degree of success, but the situation still needs to remain persistently, because the over-reliance on credit rating still exists to varying extents in the three areas mentioned. Even though the United States has removed the hardwiring of credit rating from legislation, regulations and standards, the effective alternative has not been found so far, and both the market and regulators inevitably rely on credit ratings to some extent. The elimination of credit rating references from legislation, regulations and standards in the European Union is not thorough, because the EU regulatory strategy is softer; it merely requires the regulator to remove the existing rating references when appropriate. Like the United States, the main impediment is also the lack of an alternative. Furthermore, the European Union fears not only the risk of an over-reliance on external CRAs, but is also concerned about the over-reliance on foreign CRAs. In China, the extent of the over-reliance on credit ratings is less severe than that in other areas, and the relevant regulations against over-reliance have thus shown less progress. Like the European Union, the Chinese regulatory focus is more on the risk of over-reliance on foreign CRAs. it should be noted that the market and regulators still need to rely on the credit ratings at this stage. Thus, it is necessary to continually implement the regulations against the over-reliance on the credit ratings in the long run.

Chapters 4, 5 and 6 addressed the internal factors that affecting CRA rating quality. As addressed in these chapters, owing to the inaccuracy of their ratings, CRAs should scrutinize and reflect on their rating failure during the global financial crisis. The failure of the reputation mechanism proves the necessity of strengthening regulation. Chapter 4 introduced conflicts of interest at the individual level and agency level, and the countermeasures. By comparison, rating shopping and ancillary service stemming from the conflicts at the agency level are too difficult to manage. In terms of the ancillary service, existing regulations and measures against the potential risk of ancillary service include prohibiting CRAs from providing ancillary services, and separation from rating services and ancillary services. However, as a response, parent companies of CRAs tend to set up several subsidiaries so that other subsidiaries can be responsible for ancillary services that may give rise to potential conflicts of interest with the rating service, but they are not subject to the prohibitions targeted at the CRAs. The current corporate system increases the opaqueness of relevant businesses between subsidiaries. Therefore, even though it remains difficult to manage this conflict by virtue of the existing countermeasures, it should be noted that the structured finance created huge profits in ancillary services. In terms of rating shopping, the scenario has existed for a long time, but it has been worse recently since the boom of structured finance. In this regard, in order to reduce the conflicts at the agency level, structured finance becomes a breakthrough point for regulatory reform. Most academic and regulatory discussion focuses on the change to the issuer-pays business model. A comparison of the CRA performances in corporate bonds and structured finance, under the same issuer-pays model, demonstrates that CRAs are able to provide accurate ratings on corporate bonds, while the rating quality on structured financial products cannot be ensured. Which is to say, CRAs are more likely to be unwilling, rather than unable to provide high-quality ratings. The reason for this is that the business associated with structured finance created a huge amount of revenue for CRAs. Compared to changing the business model, the reduction of relevant businesses may be another way to improve the situation. Thus, this chapter supported the reform proposal that put limitations or prohibitions on structured finance instead of the change in business model.

Chapter 5 introduced and compared the situation of the oligopolistic market structure in the European Union, United States and China. Having demonstrated that the oligopolistic market took away the threat for oligopolistic members, it further addressed the negative impacts of oligopoly on the credit rating industry and the relevant CRA regulation. For one thing, the big three lack incentives to update their methodologies and rating models. At the same time, they lack deterrence from other competitors to motivate them to improve their rating quality. For another, the oligopoly increases regulatory costs and impediments because it is hard to design a regulatory regime to motivate oligopolistic members, but also because the oligopoly of the big three raises the concern about the independence of the global big CRAs for many regions, such as the European Union. The current regulatory strategy is to enhance the competition so that new market entrants could deter the incumbent CRAs. The existing regulations include lowering barriers to market entry by approving more eligible CRAs; weakening the regulatory privileges by reducing the regulatory reliance on approved CRAs (such as NRSROs); and encouraging small and new CRAs to enter the market by offering some regulatory favouritism (such as a rotation mechanism). However, the existing regulations have not changed the oligopolistic market structure. It should be noted that the approach of greater competition indeed contributes to incentivizing the incumbent CRAs to improve their rating accuracy. The deficiency of the approach is that the greater competition cannot ensure the rating quality, while it is more likely to give rise to vicious competition under a high-competition market because CRAs often compete with one another by applying lax rating standards at the cost of their reputation – especially when the reputation mechanism does not work – rather than improving their innovation and rating accuracy. Thus, based on the existing regulatory approaches, a supplementary reform proposal is suggested to get back on track, which requires CRAs to issue a certain proportion of ratings for each rating grade. For example, the annual number of issuances of AAA rating is less than the 10 per cent of the annual total issuance of ratings. Once a CRA fails to conform with this requirement, it will become the regulatory focus for a certain period, and regulators will reinforce its supervision of it in case of its rating inflation or rating shopping.

Chapter 6 discussed the civil liability for CRAs. CRAs were broadly criticized for their inaccurate rating, and many actions for claims for damages were brought against CRAs to the courts. Investors suffered huge losses during the financial crisis, partly because they made impolitic investment decisions relying on the ratings provided by CRAs. Nevertheless, it is nearly impossible for them to prevail in damages claims against CRAs, especially prior to the financial crisis, because most investors do not have contractual relationships with CRAs. Following the financial crisis, it is time for regulators to increase market confidence and investor confidence in CRAs. As seen in Chapters 3, 4 and 5, CRAs have neither the incentive nor the deterrence to behave better. Thus, establishing civil liability for CRAs seems a good legal attempt to deter CRAs and rebuild investor confidence in the market. In order to enhance the civil liability for CRAs, the European Union, United States and China reformed or revised many relevant laws and regulations. However, by illustrating the elements required to establish CRA civil liability in the European Union, United States and China after the financial crisis, plaintiffs without contractual relationships are still faced with many impediments to holding CRAs liable under each civil law system in these regions. It is difficult to extend the civil liability for CRAs within the current civil law framework, including tort law, contract law and securities law. It is also difficult to impose an expert liability on CRAs. For one thing, the role of CRAs as expert is different from common experts, such as accountants and auditors, and the scope and context of expert liability for CRAs need to be further determined. For another, in practice, CRAs take many countermeasures to avoid expert liability. The effectiveness of private remedies needs to be further examined. In addition, the implementation of public enforcement was also examined. By comparison, public enforcement has a better deterrent effect on CRAs in each of the regions mention above. On this point, more importance should be attached to public enforcement against CRAs.

In order to better regulate CRAs, this thesis discussed the key issues related to CRAs. Although some recent progress has been noted in this thesis, there are limitations and weaknesses. Thus, future researchers could further improve on the following points: First, this thesis provides a comprehensive Chinses legal framework, which gives a good reference for further researchers to better analyse relevant Chinese issues. Like the strict prohibitions on the structured finance in Chinese law, other Chinese solutions may be meaningful approaches, of which the application of the EU and US cases would be studied to help EU and US regulatory practices to solve similar problems. Second, as mention in Chapter 5, the supplementary proposal with respect to greater competition in the credit industry could be further improved. Third, in terms of the civil liability regime for CRAs, it is extremely difficult to break through the hurdles under the existing civil law framework. In this regard, the future research could focus on the improvement of the expert liability regime or the application of the gatekeeper theory into the CRAs. Last, the future researchers could further improve the current public enforcement regime for CRAs, such as a dual-track approach that combines public and private enforcement.

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