Civil Liability of Rating Agencies: 
An Insipid Sprout from Brussels

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Civil Liability of Rating Agencies: 
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Matthias Lehmann *

Abstract: Recently, a private cause of action against rating agencies has been introduced into EU law. This paper analyses the need and justification for such liability. Features of the new cause of action are compared to those existing in other major economies; in particular, those of the U.S. and Australia. The paper criticizes the fact that the EU leaves open to Member States to define the essential terms of rating agency liability and, thereby, fails to secure a uniform regime. The problems of the new rule are compounded further by difficulties in determining the applicable national law that fills in its gaps. Finally, it remains unclear whether the scope of the liability also covers U.S. rating agencies. It is concluded that the new regime is merely a cover-up to mask continuing differences between EU Member States concerning the appropriateness of rating agencies' civil liability.

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INTRODUCTION

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

The public outcry against the seemingly all-too-powerful and unregulated rating agencies has incited a transnational legislative movement to subject them to greater scrutiny. This movement is particularly visible in the United States, where the Dodd-Frank Act has established a comprehensive framework for regulating CRAs.³ Yet the most vigorous regulatory assault on rating agencies today emerges from the European Union. Shortly after having introduced a regulation over them in 2009 (the ‘CRA Regulation’),⁴ it overhauled this regime twice in 2011.⁵ A third reform happened in May 2013.⁶ Except for banks, no other financial intermediary receives as much attention from the European legislator as rating agencies do. The EU, to a certain degree, can be held to be ‘CRA obsessed’.

The latest amendment aims at reducing reliance on ratings, guaranteeing more stability for sovereign issuers, enhancing the quality of structured products ratings, and increasing the transparency of ratings.⁷ Its main innovation, however, is the introduction of civil liability for rating agencies. The new Article 35a of the CRA Regulation permits investors and issuers to recoup losses attributed to incorrect ratings. This paper will first analyse the reasons for imposing a specific statutory liability on rating agencies. Then it will glance at examples from foreign

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² See, e.g., the criticism with regard to the four notch downgrade of Portugal by Moody’s in 2011, Financial Times, ‘Portugal Hits Back at Moody’s Downgrade’ (London, 6 July 2011).

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


⁷ See Art. 5a-c, 6a-b, 8a-d, 13 of the CRA Regulation as introduced or amended by Regulation 462/2013.
jurisdictions that have introduced such liability. Finally, the economic and comparative studies provide the necessary tools for assessing the new EU regime.

1. SHOULD RATING AGENCIES BE SUBJECT TO CIVIL LIABILITY AT ALL?

A. THE ECONOMIC FUNCTION OF RATING AGENCY CIVIL LIABILITY

Credit Rating Agencies (CRA) fulfil an important role in financial markets. They provide independent and ongoing assessments of an issuer’s creditworthiness (so-called ‘issuer rating’), and the quality of its financial instruments (so-called ‘issue rating’). Investors and supervisory authorities alike use these ratings. They are mostly made available for free to the general public and can be shared without diminishing their intrinsic value, thus creating a public good.

Rating agencies can be properly characterized as information intermediaries. They reduce information asymmetries in capital markets. If they did not exist, evaluations of issuers and instruments would have to be carried out by each investor individually. By placing this activity into the hands of a few institutions, efficiency gains are achieved. These gains are even further increased by the fact that the rating agencies have access to privileged information and dispose of the expert knowledge to independently conduct assessments, which individual investors normally do not have.

From a macroeconomic viewpoint, rating agencies act as ‘gatekeepers’. They indirectly control the entry of new risks onto financial markets. By supplying information about the creditworthiness of issuers and the quality of their instrument, they allow the market to adequately price the default risk tied to these issuers and their instruments. The worst issuers and instruments do not even enter the market because they will not obtain a sufficiently good rating.

In sum, the importance of CRAs for the functioning of modern markets can hardly be overestimated. At the same time, investors may incur losses when they base their investment decisions on ratings that subsequently prove to be incorrect. Issuers may also suffer harm because, after having been given a low rating, their

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10 See FP Hops, ‘Problems and Reforms in Mortgage-Backed Securities: Handicapping the Credit Rating Agencies’ [2009-2010] 79 Miss L J 531, 535. See also the findings of the Congress reflected in sec 931(2) of the Dodd-Frank Act, infra part B 1. On the concept of gatekeepers, see generally JC Coffee, Gatekeepers: The Professions and Corporate Governance [OUP 2006].
costs for securing financing in the market increase. That is precisely where the issue of rating agency civil liability arises.

Under the new EU Regulation, as well as under U.S. and Australian laws, claimants may sue CRAs regardless of whether a contractual connection exists.\(^{11}\) This creates a policy conundrum. While one can easily justify compensation awarded to an issuer that was improperly rated by a CRA under ordinary principles of tort law, similar justification is not so readily available for the claim of an investor who has suffered damage caused by an incorrect rating. An investor is not obliged to rely on the rating. Moreover, he typically does not pay for it. Under the current ‘issuer-pays model’, he receives his information for free since it is the issuer who pays the agency to acquire a rating. The liability that arises under the CRA regulation therefore seems like a gratis guarantee for the investor. He can effectively shift the risk inherent in his investment decisions over to the rating agencies without incurring any direct cost.

If one were to adopt the perspective taken under general private law thinking, the justification for this kind of ‘free lunch’ may appear somewhat questionable. However, such a myopic, civilian view ignores the true goal of the CRA regulation. Civil liability in this case is not primarily introduced to repair the damage done to the private investor. The objective is rather to deter rating agencies from providing false ratings. Precisely because CRAs fulfil important economic functions, there is a heightened need to sanction them when they violate regulatory rules. In other words, they must be deterred from publishing incorrect ratings. Imposing civil liability is an efficient method of deterrence.\(^ {12}\) In the U.S., the investor that brings forward a damages claim against a financial intermediary has been likened to a ‘private attorney general’.\(^ {13}\) One cannot properly understand the regime of rating agency civil liability without being clear about the fact that it serves a direct, regulatory function rather than a compensatory one.

Some authors, however, take the view that there is no need to impose civil liability on gatekeepers.\(^ {14}\) They argue that gatekeepers, such as rating agencies, need to preserve reputational capital. Providing inaccurate services would ultimately jeopardize their weight and legitimacy. They would therefore be sufficiently incentivized to avoid errors. It is even claimed further that introducing

\(^{11}\) See infra, parts B and C.
an additional civil liability regime would be dangerous because it would increase gatekeeping costs and thereby potentially stop economically beneficial activities.\textsuperscript{15} It is certainly true that there are strong market incentives that compel CRAs to issue correct ratings. Several studies show, however, that the importance of reputational capital for this type of gatekeeper has been overestimated.\textsuperscript{16} There are several reasons for that. First, the entry barrier into the credit rating market is comparatively high. To run a CRA, considerable investment and particular knowledge is necessary. Even where this is available, it will take a long time and considerable effort to close the gap built by the reputational advances of the ‘big’ rating agencies. Moreover, the fact that the rating methodology is quite opaque makes it difficult for new entrants to prove the quality of their services. Consequently, dominant agencies can, at least to a certain extent, rely on their clients’ hesitation to shift to new, unproven competitors. Finally, there is a considerable gap between short term and long-term incentives for CRAs. An agency may indeed prefer earning a ‘quick buck’ from an issuer rather than profit from long-term gains based on reputation. The experience with commission fees in relation to structured products provides clear evidence that even big CRAs are not immune to such temptations.\textsuperscript{17}

In sum, it is indisputable that fear of losing reputational capital plays a considerable role in the CRA market. Nevertheless, there are several arguments that challenge the idea that this fear suffices, in and of itself, to deter rating agencies from publishing incorrect ratings.

Another argument made against imposing civil liability on CRAs is that it could lead to investors’ overreliance on ratings.\textsuperscript{18} Overreliance occurs when ratings form the sole basis of investment decisions or when ratings are ‘mechanistically’ followed. In such circumstances, a creeping, herd-like behaviour may take hold amongst investors, where investment decisions mirror, to an exacting degree, changes in ratings. In response to the overreliance phenomenon, the Financial Stability Board has requested that governments reduce reliance on credit rating agencies when drafting laws and regulations.\textsuperscript{19} In fact, one of the main purposes behind the latest CRA regulation amendment is precisely to transpose this goal.

\textsuperscript{15} In this sense, see S Choi, ibid, 948.
into EU law, in order to discourage overreliance on ratings.\textsuperscript{20} Offering investors a right of redress against rating agencies runs somewhat counter to this aim. Where such a right is provided, there is nothing safer for the investor than to rely on a rating. In cases where common assumptions about an issuer or instrument that are expressed in a rating prove to be wrong, he can shift the risk of his investment effectively onto the rating agency. By contrast, where the rating proves to be correct, he will keep the returns on the investment. Imposing civil liability on CRAs may thus, in fact, encourage further reliance on ratings. Hence, the CRA Regulation may contradict itself when introducing such a liability and simultaneously aiming to reduce overreliance on ratings.

A closer look reveals, however, that the paradox may in fact be illusory. For one, the regulatory steps against overreliance only target institutional investors.\textsuperscript{21} Ordinary private investors would, by comparison, be completely overburdened by such in-depth financial analyses. As a result, they are able to rely on ratings as a primary source of investment information and may bring a claim against the rating agency where it has violated its regulatory duties. But even for an institutional investor, it may still be reasonable to take the rating into account because it will have limited access to information in comparison with the CRA itself.\textsuperscript{22} One cannot therefore completely bar its civil liability claims in case that the rating proves to be wrong. However, an institutional investor can be presumed to maintain the ability to counter the adverse effects of a false rating by carrying out its own research. Therefore, it will be much harder for him to show that he ‘reasonably relied’ on a false rating, as the liability provision of the new regulation presupposes.\textsuperscript{23} As a result, CRAs will be liable to institutional investors less often than to retail investors.

In sum, if carefully curtailed and limited, investors’ remedies for undue loss do not significantly increase the risk of herd behaviour. Making CRAs liable for false ratings and reducing overreliance on ratings are therefore not completely contradictory aims.

B. ARE STATE COURTS WELL-POSITIONED TO JUDGE OVER CRAS?

Another argument against rating agency liability is that such a remedy effectively allows state bodies to second guess the accuracy of credit ratings. There are at least two good reasons as to why the State may not be in a favourable position to effectively exercise this power. First, State organs do not have the expert knowledge that the CRAs use to rate issuers and instruments. CRAs employ

\textsuperscript{20} See Regulation 462/2013, Preamble 9.
\textsuperscript{21} See Art. 5a CRA Regulation.
\textsuperscript{22} See also Regulation 462/2013, Preamble 36, second sentence.
\textsuperscript{23} See Art. 35a(1) subpara. 2 CRA Regulation.
sophisticated methods to assess the risk of failure.\footnote{See e.g. CE Bannier and CW Hirsch, The Economic Function of Credit Rating Agencies – What Does the Watchlist Tell Us? [2010] 34 J of Banking and Finance 3037.} Public bodies, as arbiters, are unlikely to master these methods to the degree attained by the CRAs. Second, States may face conflicts of interest when simultaneously acting in a regulatory capacity, as supervisors of CRAs, and in a commercial capacity, as issuers. Under these circumstances, there is a danger that they might abuse their regulatory authority in order to improve their own position as an issuer. To avoid such conflicts, CRAs must be independent from the State when the latter acts as a borrower on the market. The autonomy of the rating system needs to be held intact. Otherwise, market participants will not be treated on an equal footing.

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

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

C. \textbf{THE FREEDOM OF SPEECH PROBLEM}

One particular argument that is often advanced against the imposition of civil liability for ratings is that they merely constitute opinions, and not facts. This is a common defence raised by rating agencies when sued by investors or issuers.\footnote{See, e.g., the testimony of RM Bolger, Managing Director and Associate General Counsel of Standard & Poor’s, before the United States House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises, 109th Cong 16 [2005].} It has special force in the United States because freedom of speech is comprehensively protected under the First Amendment to the U.S. Constitution. Given that the freedom of expression is also enshrined in the European Convention of Human Rights and in the Charter of Fundamental Rights,\footnote{Art. 10 European Convention on Human Rights; Art. 11 European Charter of Fundamental Rights.} the argument is of interest in the EU as well.\footnote{Recital 8 of Regulation (EU) 462/2013, which expressly states that ratings ‘are not mere opinions’ is unhelpful in this context because it does not provide a reason argument for this statement.}
Quite a number of U.S. courts have opined that credit ratings enjoy First Amendment protection as so-called ‘commercial speech’.\textsuperscript{28} Several courts have, however, excluded ratings that were disseminated to a selected group of investors, on the basis that only public speech is protected under the First Amendment.\textsuperscript{29} Yet from a regulatory viewpoint, the distinction between ratings distributed to a select group and ratings disseminated to the public at large seems unconvincing.\textsuperscript{30} The interest in correct ratings does not diminish if the rating is addressed to a group from those in which it is made available to the general public.\textsuperscript{31} As an illustration, one may imagine a case where a rating that was originally directed to a group is later published by the media.

The correct distinction lies elsewhere. Given that a rating is, in fact, a forecast on an issuer's ability to honour its obligations in the future, it is undisputed that there is a certain element of opinion built into it. Ratings are merely prognoses, and as such, are subject to error even where the most exacting standards have been met. That is not the same as to say that CRAs merely state opinions. Instead, rating agencies expressly or implicitly claim to have conducted a thorough review of the financial condition of the issuer and the terms of his offer, based on a comprehensive analysis of facts. This claim is precisely why investors subscribe to ratings. Investors do not rely on mere opinions, but rather on the facts that allegedly support them. If and where these facts are wrong, liability should be imposed.\textsuperscript{32} Rating agencies do not deserve protection where the factual basis of their ratings is false or where they have failed to properly analyse underlying facts. This conforms also to the U.S. Constitution because the First Amendment does not bar the courts from sanctioning false and deceptive speech,\textsuperscript{33} independent of whether one considers ratings as free speech in the sense of this provision.

\textsuperscript{28} See Compuware Corp v Moody's Inv Servs Inc, 499 F.3d 520, 529 (6th Cir.2007); Jefferson County Sch Dist No R–I v Moody's Inv Servs Inc, 175 F.3d 848, 856 (10th Cir.1999); First Equity Corp v Standard & Poor's Corp, 690 F.Supp.256, 260 (S.D.N.Y.1988).


\textsuperscript{30} For an equally critical account, see C Deats, 'Talk That Isn't Cheap: Does the First Amendment Protect Credit Rating Agency’s Faulty Methodologies From Regulation?' [2010] 110 Columbia L. Rev 1818, 1846-1850.

\textsuperscript{31} See C Deats, ibid, footnote 147.

\textsuperscript{32} See also JP Hunt, ‘Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement’ [2009] Columbia Business L Rev 109, 183-188.

D. **NECESSARY LIMITS TO CRA LIABILITY**

The foregoing analysis illustrates that there are solid arguments for holding CRAs liable when they issue false credit ratings. That said, there are several, equally good arguments for limiting their liability. First, CRAs, as gatekeepers, could be overly deterred from making independent ratings by the risk of liability imposed on them if their ratings should subsequently prove to be wrong. Moreover, given the element of prognosis inherent in every rating, liability should not apply where the agency investigated the facts properly and merely drew the wrong conclusions. It must also be taken into account that overreliance on ratings would be encouraged if investors were able to shift the risk of their investment decisions to rating agencies. Finally, it is important to note that state judges do not have the requisite knowledge to effectively second guess the adequacy of a rating. Taken together, these points make a strong argument for limiting rating agencies’ liabilities. The problem is that these limits are not easy to define. The legislator must aim to strike a delicate balance between over-deterrence and under-deterrence of CRAs.

One suggested solution is to impose maximum limits on CRAs liability for false ratings.\(^{34}\) This proposal certainly has its merits. A ceiling on liability would prevent CRAs from being forced out of the market simply because of a false rating. Limited liability can also be more easily insured than unlimited liability. Finally, a regulator may likely be able to fine-tune liability to reflect the most appropriate point of balance between under- and over-deterrence.

Yet there are also drawbacks to the introduction of a ceiling to cap liability. If a uniform ceiling is set, it could under-deter large CRAs while simultaneously putting smaller ones out of business. To avoid this outcome, one suggestion has been to vary liability limits depending on the size of the CRA.\(^{35}\) A moving ceiling, however, may lead to a considerable disadvantage for small CRAs. The market may view them as being comparatively less trustworthy than larger CRAs with higher potential responsibility, thus raising barriers to market entry even higher. Moreover, one may question from the perspective of the principle of equal treatment why an issuer or investor should have fewer rights against a small CRA than against a big one. The same doubts apply to an alternate proposal that the threshold should be defined as a function of the fees collected by the CRA.\(^{36}\)

The most important argument against a fixed cap on liability, however, is that it does not allow for any differentiation between the type and the gravity of the error committed. A set threshold cannot distinguish between minor and major misbehaviour. A rating agency could invoke it even where it has committed a most serious and avoidable blunder. Such a result is hard to explain and gives rise to wrong incentives. In general, fixed ceilings are appropriate only for cases of strict

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\(^{35}\) G Wagner, ibid, 493.

\(^{36}\) G Wagner, ibid, 493-494.
liability. They are not appropriate to limit liability for intentional and negligent, or ‘culpa’ based acts. CRA liability precisely belongs to this type.

Instead, the analysis carried out here suggests different types of limitations. Basically, CRA liability should be restricted in two ways. First, the rating agency should only be liable where it has not based its decisions on correct facts, or alternatively where it has failed to correctly apply its own methodology when analysing the facts. This restriction is necessary because a rating is essentially a sort of prognosis, which can be disproved by future events. In addition, it serves as a measure against overreliance by investors who should be encouraged to carry out their own assessment. Second, liability should apply only for the most egregious of errors. Without this restriction, CRAs would be deterred from carrying out their economically beneficial functions as information intermediaries and gatekeepers. It can also be justified by the fact that the rating is obtained for free by investors. They should be incentivized to enter into a contract and buy a rating if they want to submit the CRA to stricter liability.

The two limits regarding the types and quality of errors that have been elaborated are reflected in some way or another in comparative law, as will be shown.

2. COMPARATIVE CONTEXT

Before the EU, other States already introduced or applied causes of action against CRAs. It is striking that these are not jurisdictions that flirt with socialist ideas or otherwise tend to unduly curtail the free market. They are, instead, major capitalist economies with a developed financial industry.

A. UNITED STATES: STATUTORY CAUSES OF ACTION WITH SPECIFIC PROBLEMS

The law of the U.S. is of particular importance in the context of the question analysed here because the three largest CRAs – Standard & Poor’s, Moody’s and Fitch – have their headquarters in New York City (with Fitch simultaneously being headquartered in London). The question as to whether they are liable for incorrect ratings has been answered differently at different times; a testament to a constantly changing attitude. For a long time, U.S. courts have hesitated to grant claims against CRAs. But in the wake of the financial crisis and as a reaction to calls for increased responsibility by CRAs, Congress has introduced statutory responsibility for ratings. This was accomplished through the Dodd-Frank Act, which amended several longstanding federal securities laws.

37 See the discussion on the First Amendment, supra 1 C.
The first of these amendments concerns the Securities Exchange Act of 1934. Credit ratings are now subject to the same enforcement and penalty provisions that apply to statements made by registered public accounting firms and securities analysts. Moreover, ratings no longer fall under the safe-harbour in Section 21E of the Act that exempts any forward-looking statements from liability. Hence, ratings from now on are governed by the general rules of the Act; in particular to section 10(b) and Rule 10b-5 promulgated thereunder which prohibits fraud and deceit as well as the making of an untrue statement or omission of a material fact in connection with the purchase or sale of securities. The rigidity of this standard is normally mitigated by specific pleading requirements pursuant to which the claimant has to state with particularity facts giving rise to a strong inference that the defendant acted with the statutorily required state of mind. In case of section 10(b), this statutorily required state of mind is scintener. The pleading requirement thus poses a very high barrier for any claimant to overcome. Yet the legislator has introduced a special exception for money claims against rating agencies. For such actions, it is sufficient for the claimant to plead with particularity one of two sets of circumstances. He must state either that the CRA failed to conduct a reasonable investigation of the rated security, or that it failed to obtain reasonable verification of factual elements from other sources than the issuer and underwriters themselves. One can clearly see the similarity to the ‘facts test’ that has been suggested above. Moreover, it is necessary to show that the CRA ‘knowingly or recklessly’ failed to comply with one of these two duties. This is the ‘egregious error requirement’ mentioned earlier. In sum, the claimant needs to show that the CRA did not conduct a reasonable investigation or reasonable verification although it was plainly necessary. In addition, he must also plead that he suffered a loss due to the CRA’s omission.

Still this may be too high a hurdle for many claimants to overcome. That is why another cause of action is arguably even more important. Section 11 of the Securities Act of 1933 concerns liability for false registration statements. Until 2010, rating agencies were exempted from liability under this provision due to a special rule promulgated by the Securities and Exchange Commission (SEC) which did not recognize credit ratings as registration statements despite being vital to the public offering. The Dodd-Frank Act subsequently repealed this rule.

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42 See supra 1 D.
43 See supra 1 D.
44 See supra 1 D.
45 Rule 436(g).
46 See section 939G Dodd-Frank Act. Rule 436(g) was formerly codified as 17 CFR 230.436.
This effectively means that CRAs are no longer shielded from liability under section 11 of the Securities Act of 1933. The liability provided for in this provision is particularly attractive to a prospective claimant because he will only be required to show three facts that can be proven relatively easily: that he purchased a security after the rating had been issued, that the rating agency identified in the complaint is one of the parties enumerated in section 11, and that the rating contained an untrue statement or omission of material fact.\footnote{See AM Grishteyn, ‘Horseshoes and Hand Grenades: The Dodd-Frank Act’s (Almost) Attack on Credit Rating Agencies’ [2010-2011] 39 Hofstra L. Rev 937, 959.} There is no need for a claimant to show that he relied on the CRA’s statement, or that the CRA acted knowingly or recklessly, or that the loss was caused by the false rating,\footnote{AM Grishteyn, ibid, 960.} as is necessary under the Securities Exchange Act of 1934.

It is true that even under section 11 of the Securities Act, seeing a claim through to victory is not easy. That is because courts have refused to qualify rating agencies as underwriters in the sense of this provision.\footnote{For an example of the non-application of section 11(a)(4) of the Securities Act of 1933, see In re Lehman Bros Mortgage-Backed Securities Litigation, 650 F.3d 167, 175-185 (2d Cir. 2011).} There is, however, the possibility to sue them in their capacity as experts named in the registration statement.\footnote{See section 11(a)(4) of the Securities Act of 1933.} Shortly after the Dodd-Frank Act repealed the exemption granted by the SEC, CRAs tried to preclude this possibility by refusing to have their ratings included in the registration statements.\footnote{B Brownlow, ‘Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities’ [2001] 15 N C Banking Inst 111; B Haar, ‘Civil Liability of Credit Rating Agencies – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence’, available online at ssrn.com (last visited 25 November 2013); J Manns, ‘Downgrading Rating Agency Reform’ [2013] 81 George Washington University L. Rev 749, 774.} This could have completely frozen the market for asset-backed securities (ABS), which rely on such ratings. In the face of this threat, the SEC issued a no-action letter in which it declared that it would temporarily withhold enforcement where an ABS issuer omits the ratings disclosure in the registration statement.\footnote{SEC, No-Action Letter, Ford Motor Credit Company LLC, 22 July 22 2010.} This relief was later extended ‘pending further notice’.\footnote{SEC, No-Action Letter, Ford Motor Credit Company LLC, 23 November 2010.} For the time being, rating agencies have therefore effectively managed to avoid liability under section 11 of the Securities Act 1933 in relation to ABS.

The fate of liability under U.S. laws illustrates the fierce power play going on between the legislator, the regulator, and the industry. The emerging impression that the industry has had the upper hand is, however, only partly correct. The no-action letters by the SEC are limited to ABS issuers. They do not apply to issuers of ordinary stock and bonds, which are obliged to include relevant ratings in the registration statement. Moreover, the relief granted by the regulator is merely temporary and may be revoked at any time. Should problems with ABS ratings occur in the future, the SEC may find it difficult to continue to uphold its relief in
the face of mounting political pressure. For these reasons, it is not an exaggeration to say that U.S. law offers fertile ground for claims against rating agencies.

B. **AUSTRALIA: MIXED COMMON LAW AND STATUTORY LIABILITY**

Australia provides another guiding example for rating agencies’ civil liability. In fact, it was there that a significant damages claim against one of the three major rating agencies was granted for the first time. In *Bathurst Regional Council v Local Government Financial Services Pty Ltd.*, the Federal Court for the New South Wales District Registry ordered Standard and Poor’s (S&P) to pay more than A$ 20 Mil.\(^{54}\)

The claimants in this case were local councils that had collectively invested in so-called Constant Proportion Debt Obligations (CPDOs) through a common intermediary. S&P had given an ‘AAA’ rating to these instruments. The instruments were later discovered to be extremely volatile: In less than two years following the claimants’ purchase, they lost more than 90% of their initial value. In a meticulously drafted 1459 page long decision, Judge Jagot came to the conclusion that, but for this fact alone, the CPDOs could not have been rationally rated ‘AAA’.\(^{55}\)

The first ground upon which the decision is based is the common law tort of negligence.\(^{56}\) Under Australian law, negligence requires a showing that the defendant has breached a duty of care.\(^{57}\) Judge Jagot indeed held that S&P owed such a duty to the defendants.\(^{58}\) For this ruling, she very much relied on the particular facts of the case. Contrary to most other rating agencies, S&P could foresee to whom the instruments were to be sold since they were bespoke to certain investors, and there was no secondary market for them. Because of this particularity, it was easy for the judge to reject S&P’s argument that the liability alleged against it would be ‘indeterminate’ since it had no contractual relation with the claimants.\(^{59}\) Moreover, the fact that the investors were particularly “vulnerable” to the rating played a key role in the ruling. The judge stressed that the local councils, in their capacity as governmental bodies, are required to only purchase financial instruments of a certain quality and were not able to second-guess the rating issued by the agency.\(^{60}\) Finally, the case was also very specific in

\(^{54}\) *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200.* The entity that was the actual defendant was the UK subsidiary of McGraw Hill Financial Inc, known as S&P, see margin no 13 of the judgment.

\(^{55}\) *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200,* margin no. 22.

\(^{56}\) See *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200,* margin no. 2741 et seq.

\(^{57}\) See section 5 Australian Civil Liabilities Act 2002.

\(^{58}\) *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200,* margin no. 2742 et seq.

\(^{59}\) *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200,* margin nos. 2745 et seq., in particular margin no. 2754.

\(^{60}\) *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200,* margin no. 2767 et seq., in particular margin no. 2772.
that S&P had committed egregious errors. In determining the rating, it relied on information provided exclusively by the issuer itself (ABN Amro) regarding performance of the instrument without ever verifying them independently. This information later turned out to be false. Moreover, it had given ABN Amro insight into its rating methodology, thus providing it with an opportunity to ‘game’ the process by structuring the product so that it would obtain the highest rating.

The particularities of the case limit the significance of the ruling as it pertains to the law of negligence. The decision hinges instead on the specific qualities of the defendants and the egregious errors committed by the claimant. It is not clear how the Australian courts would decide otherwise if the rating agency’s mistake concerned a standard product sold to ordinary investors and traded on a secondary market. Moreover, courts in other common law countries may be much more reluctant to recognise a duty of care where privity of contract does not exist.61

It is important to note, however, that the decision is also based on a second cause of action. Section 1041I of the Australian Corporations Act allows recovery for those who have suffered loss from the violation of the four preceding provisions. Section 1041H of the same Act contains a prohibition to engage in misleading or deceptive conduct in relation to a financial product or service. The court ruled that S&P had violated this prohibition.62 It held that, by assigning and authorising the AAA rating, the agency had represented itself as an expert to all potential investors by declaring that the issuer’s capacity to pay any claims under the CPDOs was extremely strong, and that this opinion was based on reasonable grounds.63 In light of its foregoing determinations as to how this opinion came about, in particular S&P’s insufficient verification of the data provided by the issuer, the court considered this representation to be ‘misleading and deceptive’.64 The court also found that all other requisites of liability under section 1041I the Australian Corporation Act were met.

This second prong of the judgment is even more far-reaching than the first. On this point, the court does not rely on particularities of the case. Instead, it assumes that the representations are based on circumstances that are often present when ratings go awry. One must therefore conclude that under Australian law, rating agency civil liability is a reality. However, S&P had announced its intention to appeal Judge Jagot’s decision. One will have to wait for the result in order to know whether rating agencies indeed have to fear Australian courts.

62 Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200, margin no. 2884 et seq.
63 Ibid., margin no. 2919.
64 Ibid., margin no. 2919.
C. **France: Strict Statutory Liability**

In 2010, the French legislature decided that it must act against what it thought to be serious failures of CRAs during the financial crisis. It introduced an explicit statutory damages claim against rating agencies. This cause of action, providing for the tortuous and ‘quasi-tortuous’ liability of a CRA, is not only available for clients, but also for third parties. Apart from damage and causation, the only condition is that the claimant shows that the CRA had violated its duties under EU law, specifically under the CRA Regulation. It does not matter whether the violation was done because of gross or simple negligence. In addition, it does not matter whether there is a specially held duty by the CRA towards the investor.

When comparing the French rule to the U.S. and Australian laws, it is evident that the first is considerably stricter on CRAs. There is no need for the claimant to show any negligence, recklessness or misrepresentation on the part of the agency. The mere fact that the rating is not in conformity with the regulatory duties under EU law and that it leads to damage to the investor suffices to trigger liability.

Should the law have remained and effectively been applied by the French courts, it would have certainly resulted in over-deterrence. Yet in the meanwhile, the EU regime intervened. Although the French Act is not yet repealed, it can no longer be applied because of the supranational rank of the CRA Regulation.

3. **The European Variant of CRA Liability**

A. **The EU Regime at a Glance: Regulation-Annexed Liability**

When contrasting the EU rule on rating agencies’ liability with those of the United States, Australia and France, a couple of points immediately meet the eye. New Article 35a(1) of the CRA Regulation reads:

> Where a credit rating agency has committed, intentionally or with gross negligence, any of the infringements listed in Annex III having an impact on a credit rating, an investor or issuer may claim damages from that credit rating agency for damage caused to it due to that infringement.

The focal point of the provision is the existence of an infringement listed in Annex III of the Regulation. EU law does not presuppose a showing of any violation of a duty of care or misrepresentation, as is required under, e.g., Australian law. It is also not necessary to prove any fraud or deceit or the making

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of an untrue statement or omission of a material fact, as it is under section 10b of
the U.S. Securities and Exchange Act. What is necessary, though, is that one of the
regulatory duties has been violated. Liability here is thus ‘regulation annexed’. This
demonstrates the clear relation of the private cause of action to the enforcement
of broader policies, which has already been mentioned.\textsuperscript{66}

The regulatory duties that underlie the new regime are very elaborate. Annex
III to the CRA Regulation enumerates no less than 84 different types of
infringements. Because some of these infringements concern not only a single, but
a whole spectrum of duties, the total number of duties that rating agencies have to
comply with is even higher.\textsuperscript{67} In practice, however, disputes will probably centre
only on a few types of infringements. This is due to the fact that not many of
them are likely to cause damage to investors or issuers. Most concern the CRA’s
organization, for instance, such as requiring a certain number of independent
directors and prescribing certain remuneration schemes.\textsuperscript{68} It will be hard, if not
impossible, for the claimant to show that an infringement of this type of duty has
led to damage. The infringements that are most likely to serve as a foundation for
a liability claim are mainly two. The first is the CRA’s failure to use all available
information that is relevant according to its own rating methodology.\textsuperscript{69} The
second is the failure to use rigorous, systematic, continuous methodologies that
are subject to validation based on historical experience, including back-testing.\textsuperscript{70}
These infringements are strikingly similar to those the claimant must plead under
the U.S. Securities Exchange Act of 1934.\textsuperscript{71}

Another condition for liability is the existence of damage caused by the
infringement. Interestingly, the regulation does not presuppose that the damage
resulted from a ‘wrong’ or ‘false’ rating. Given the element of prognosis inherent
in any rating, it was wise to avoid the need for such qualification. Nevertheless, the
regulation requires that the infringement must have had, at least, an ‘impact’ on
the rating. This condition allows for excluding claims where the rating would have
been the same without any infringement of a regulatory duty. There is no reason
to protect, e.g., an investor where the rating he has relied upon has not changed as
a result of an infringement.\textsuperscript{72}

Liability under Article 35a is incurred only if the infringement has been
committed intentionally or with gross negligence. The preamble of the Amending
Regulation justifies this restriction with the degree of assessment of complex

\textsuperscript{66} See supra 1 A.
\textsuperscript{67} See, e.g., No. I 1 of Annex III which refers to the infringement of one of the conditions set down in
Article 4(5). The latter provision lists eight conditions for the practically enormously important
endorsement of a credit rating issued in a third country.
\textsuperscript{68} See CRA Regulation, Annex III No. I 6 and 7.
\textsuperscript{69} CRA Regulation, Annex III No. I 42.
\textsuperscript{70} CRA Regulation, Annex III No. I 43.
\textsuperscript{71} See supra 1 B.
\textsuperscript{72} See M Gietzelt and J Ungerer, ‘Die neue zivilrechtliche Haftung von Ratingagenturen nach
Union – GPR) 333, 341.
economical factors that the rating agency has to carry out and with its potentially unlimited liability under the new law.\textsuperscript{73} Indeed, it has been shown that a limitation of this type is necessary for several reasons.\textsuperscript{74} Moreover, the exclusion of mere negligence is strongly reminiscent of U.S. law, where the claimant has to state with particularity that the agency violated its duties ‘knowingly or recklessly’.\textsuperscript{75} One may thus say that a transatlantic standard of liability has been established. Contractual deviations are allowed, but they can be agreed on in advance only if they are reasonable, proportionate and allowed under national law.\textsuperscript{76}

The regulation dedicates some provisions to the claimant’s standing. Insofar, it distinguishes between investors and issuers. Investors are required to establish that they have reasonably relied on the rating.\textsuperscript{77} Issuers damaged by an incorrect rating, in contrast, generally have standing except when they themselves have provided information that led to the incorrect rating.\textsuperscript{78} The latter limitation is somewhat self-understood.

CRA liability needs to be carefully designed. Particularly complex, but at the same time very important, are the law’s procedural aspects. The standards contained in this regard in Article 35(2) of the CRA regulation provide a particularly illustrative example of the delicate balance that a legislator must strike to steer clear between the Scylla and Charybdis of under-deterring and over-deterring rating agencies. The EU Commission’s proposal set out that if an investor establishes facts suggesting that a CRA has committed an error, then the agency must prove it has not committed this particular infringement.\textsuperscript{79} The problem was that this provision did not list or illustrate the kind of facts an investor had to establish or explain the degree of certainty that was required. One must therefore consider it fortunate that during the ensuing legislative process this clause was considerably amended. The finally adopted version of Article 35a(2), subparagraph 1 makes the claimant responsible for presenting accurate and detailed information showing that the credit rating agency has committed an infringement of the Regulation. Subparagraph 2 of the same provision leaves it to each national court to decide on the level of accuracy and detail required. This is of no surprise since it is always the court that interprets and applies legal requirements. But the CRA Regulation provides that in doing so, the court shall take ‘into consideration that the investor or issuer may not have access to information which is purely within the sphere of the credit rating agency’.\textsuperscript{80} The interplay of the two subparagraphs of Article 35a(2) is somewhat obscure. One author has concluded that it would effectively suffice for the investor to allege an

\textsuperscript{73} Recital 33 Regulation 462/2013.
\textsuperscript{74} See supra 1 D.
\textsuperscript{75} See supra 1 B.
\textsuperscript{76} Art. 36a(3) CRA Regulation.
\textsuperscript{77} Art. 36a(1) subpara. 2 CRA Regulation.
\textsuperscript{78} Art. 36a(1) subpara. 3 CRA Regulation.
\textsuperscript{80} Art. 35(2) subpara. 2 CRA Regulation.
infringement by the agency and an impact on the rating. But that would devoid
the principle of the first subparagraph of any meaning. One should rather
understand the two provisions together: The claimant has to state, *insofar as possible for him*, detailed and accurate information about an infringement and its impact on
the rating. The assessment of what is possible for him, in turn, has to be made by
each national court on a case-by-case basis.

B. **The Continuing Importance of Member State Law**

The most innovative and at the same time very problematic feature of the new
liability provision is its relation to national law. Article 35a of the CRA Regulation
contains a number of general terms that need interpretation, such as ‘damage’,
‘gross negligence’, or ‘reasonably relied’. The EU legislator has chosen not to
define them. Instead, it refers in Article 35a(4) to the ‘applicable national law’ for
their interpretation and application.

This is novel. So far, it was considered to be a basic tenet of EU law that
terms contained in regulations had to be interpreted autonomously without any
reference to national law or to legal concepts of the Member States. If the
European legislator wants to leave some room for the Member States, he can use a
directive. Yet, while even a directive contains a core that has to be interpreted
autonomously, the new CRA Amending Regulation goes further by placing the
core of the EU text at the disposal of the Member States. In doing so, it effectively
turns the relationship between European and Member State law on its head. The
method it follows could be called a ‘nationally autonomous interpretation’ of EU
law.

It is true that even EU regulations may necessitate accompanying legislation.
Many of them explicitly require implementing measures on the national level. Member State law often designates the competent institutions or the details of the

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81 A Dutta, ‘Die neuen Haftungsregeln für Ratingagenturen in der Europäischen Union: Zwischen
Sachrechtsvereinheitlichung und europäischem Entscheidungseinklang’ [2013] Wertpapier-Mitteilungen
1729, 1734.

82 See e.g. H Rösler in J Basedow, KJ Hopt, R Zimmermann and A Stier (eds.), Max Planck
Encyclopedia of European Private Law, [OUP 2012], lemma ‘Interpretation of EU Law’, p. 979. From the case law of the
ECJ, see recently Case C-254/11 Szabolcs-Szatmár-Bereg Megyei Rendőrkapitányúgyúgy Zátony Határrészészeti
Környéktétele v Shomodi, decision of 21 March 2013, no 24. From the former case law, see e.g. ECJ Case C-

83 See e.g. Art. 16(1) of Regulation 261/2004 establishing common rules on compensation and assistance
to passengers in the event of denied boarding and of cancellation or long delay of flights, OJ L 46,
17.2.2004, p. 1; Art. 27(1), 30(1) of Regulation 1371/2007 on rail passengers’ rights and obligations, OJ L
procedure to be followed. The ECJ has accepted that there may be a need for such references.

Some regulations also allow Member States to define a certain term used. What is surprising about Article 35a(4) CRA Regulation is not the fact that it refers to national law, but rather the extent to which such reference is made. The regulation relies on Member States to define terms such as ‘damage’, ‘intention’, ‘gross negligence’, ‘reasonably relied’, ‘due care’, ‘impact’, ‘reasonable’ and ‘proportionate’. This is not only an unusually high number, but these are also the core terms of the liability provision. Moreover, one must take note of the fact that the list is not exhaustive. The use of the words ‘such as’ indicates that even more terms may have to be interpreted under national law.

Leaving so many core terms to the discretion of national legislators leads to problems. Normally, a regulation aims to achieve a uniform legal situation in the EU. This is also the proclaimed goal of the CRA amendment. Where the Member States each have the right to select the meaning of the core terms of an EU regulation, uniformity becomes illusory. In this respect, it is of lesser importance that Article 35a(5) CRA Regulation allows Member States to adopt more stringent rules on civil liability. The real problem is that the regulation does not even define a clear minimum level of liability. It provides merely a colouring page that must be filled in by the Member States.

The UK has already exploited the opportunity opened up by the Amending Regulation. Shortly after its entry into force, it adopted the Credit Rating Agencies (Civil Liability) Regulations 2013. Together with the EU Regulation, it now contains the statutory basis for claims against CRAs in the UK. It is therefore no longer possible to use the common law remedy of estoppel as an interpretation of the EU Regulation, as has been suggested in the literature. Instead, the Credit Rating Agencies (Civil Liability) Regulations 2013 put some flesh onto some key terms that the European legislator has left open. For example, the term ‘gross negligence’ is defined to mean that the senior management was ‘reckless’ as to whether the infringement occurred, where reckless means acting ‘without caring whether an infringement occurs’. Although this standard superficially seems similar to U.S. law, it is comparatively high because the term ‘reckless’ is used in the UK more often in criminal law than in a civil or commercial context. However, the standard of ‘recklessness’ also applies with regard to issuer liability.

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84 See for example Article 20(1) of Regulation 805/2004 creating a European Enforcement Order for uncontested claims, OJ L 143, 30.4.2004, p. 15.
87 See Art 288 para 2 TFEU, stating that a regulation shall have ‘general application’.
88 See Recital 2 CRA Regulation according to which the regulation aims at ‘convergence’.
91 Section 4(1) Credit Rating Agencies (Civil Liability) Regulations 2013.
for false and misleading statements.\textsuperscript{92} Any suspicions of a violation of the EU principle of equivalence\textsuperscript{93} would therefore be unfounded.

Other Member States have so far been reluctant to adopt special definitions for CRA liability. They are content with the application of their ordinary principles of civil law. No matter whether a specific legislation is adopted or not, in the end rating agencies will not be subject to the same rules in the Member States. Rather, their liability will hinge on national particularities. The result is a patchwork of different rules. The CRA not only does nothing to overcome this diversity, but instead explicitly accepts it. Uniformity may also not be brought about by the ECJ. Since all key terms of Article 35a CRA Regulation are subject to national law, there is very little space for references for a preliminary ruling. The Commission will also find it difficult to sue a Member State for not having applied the regulation correctly. The latter may always retort that the meaning of the regulation’s core is left to the sovereign interpretation by the national legislature.

Given that the Amending Regulation does not impose any clear obligations on the Member States and cannot be applied without reference to a national law, one may reasonably doubt that it features the two main characteristics of a regulation: its binding nature and its direct applicability.\textsuperscript{94} One may also suspect that it has a shaky legal foundation. Article 114 TFEU, which is invoked in its preamble, is situated in the chapter on the ‘approximation of laws’. However, the Regulation does not lead to such an approximation. In fact, it does the opposite. By calling upon each Member State to adopt its own version of the cause of action, it sets the divergences between national laws in stone.

It is of course interesting to speculate about the reasons why such a provision has been adopted. One may argue, for instance, that given the absence of a comprehensive civil law by the EU, it would be impossible to autonomously define key terms of tort law such as ‘damage’, ‘intention’, ‘gross negligence’, ‘due care’ or ‘reasonable’. Yet such an argument would fail. The Product Liability Directive, for example, contains many terms of tort law and gives them autonomous meaning.\textsuperscript{95} The ECJ has also famously defined the term ‘damage’ to encompass immaterial loss.\textsuperscript{96} If necessary, it could have given more interpretative guidelines. But this possibility has been blocked by the reference to national law.

The true reason must therefore lay elsewhere. The history of the new rule provides some clues about the drafters’ intentions. The reference to national law was not foreseen in the proposal submitted by the Commission.\textsuperscript{97} It was

\textsuperscript{92} See section 1270 Companies Act 2006, Schedule 10a section 3(2) of the Financial Services and Markets Act (FSMA).
\textsuperscript{93} See ECJ Case C-118/08 Transportes Urbanos y Servicios Generales S.A.L. v Administración del Estado para 33 ss.
\textsuperscript{94} See Art. 288(1) TFEU.
\textsuperscript{97} See COM(2011), 747 final, p. 33.
introduced in the Resolution of the European Parliament dated 16 January 2013\(^98\) which, in general, had the effect of watering down the Commission’s proposal. The suggestion to include a reference to national law came from the European Parliament’s rapporteur Leonardo Domenici.\(^99\) He justified it with the argument that ‘certain points need clarifying and strengthening in order to avoid undesirable effects when measures are implemented’.\(^100\) In fact, his amendment did quite the opposite. Apart from the general requirement that there must be some liability for regulatory infringements by rating agencies, it has left important details to the discretion of the national legislators. As a result, Member States will continue to determine rating agency liability. In other words, the situation has not changed much due to the adoption of the EU regulation. Like a Trojan horse, the introduction of the reference to national law has eroded the proposal from the inside.

We may in fact witness here a new strategy. Referring the details of a regulation to Member States is in fact a very convenient way to mask political disagreement. European Parliamentarians were able to endorse the draft independent of whether they liked rating agency liability or not. In times where the public does not stop complaining about too much intrusion and overregulation by the EU, it must have seemed very sensible for them to transfer some responsibility back to the Member States. At the same time, they avoided the risk of their constituencies reproaching them that the European Parliament would not have acted against rating agencies.

The governments represented in the Council were happy to follow the path shown to them by the Parliament. There was something in the new draft for everybody. Those governments that wanted some visible action against rating agencies could point to the fact that liability was introduced. And those who secretly nurtured doubts about the wisdom of such liability could take comfort in the thought that they would still have an opportunity on the national level to determine how far such liability actually went.

The resulting compromise is very strange indeed. We now have an EU cause of action on the books. But in order to know whether a rating agency is liable, one will have to look to Member State law. Empty law-making has never been done more artfully. But there is no reason for the EU bodies to congratulate themselves. Their latest trick may backfire once the public becomes fully aware that the Regulation is for the Member States just the staging of a new version of ‘As you


\(^{99}\) Committee on Economic and Social Affairs, Rapporteur Leonardo Domenici, Report on the proposal for a regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies (COM(2011)0747 – C7-0420/2011 – 2011/0361(COD)), 23.8.2012, A7-0221/2012, p. 68. The report suggested referring to the national law of the country in which the investor sustaining the damage had his or her domicile when the damage occurred. This has later been changed. For the effects, see infra 3 C.

\(^{100}\) Id., p. 80.
Far from having strengthened the EU, it may endanger its importance and its credibility as a lawmaker.

C. DIFFICULTIES IN DETERMINING THE APPLICABLE LAW

The problems do not stop here. They are compounded by a further difficulty. As has been seen, Article 35(4) CRA Regulation sets out that the terms not defined in the liability provision 'shall be interpreted and applied in accordance with the applicable national law’. This wording implies that there is always a rule of substantive national law that fills in the gaps left by the European legislator. However, this is not the case. For instance, it might be that a country does not recognize a concept such as ‘gross negligence’ or ‘reasonably relied’. In this case, the reference leads to a vacuum. It is also possible that a legal system provides different definitions for these terms, for instance, depending on the branch or industry concerned. The EU Regulation’s reference to national law then leads to confusion.

The even bigger problem is finding out which national law applies. According to the regulation, the answer depends on the ‘relevant rules of private international law’. The regulation gives the impression that finding and applying these ‘relevant rules’ would be an easy task. The opposite is true. Private international law in the EU, as far as obligations are concerned, is determined by the Rome Regulations. The Rome I Regulation applies to contractual obligations, whereas the Rome II Regulation designates the law that governs non-contractual obligations. According to ECJ case law, a contractual obligation is an obligation ‘freely assumed by one party towards another’. Such an obligation is present where a rating has been solicited. In this case, the governing law will be determined by Rome I. Accordingly, the parties can freely determine the applicable law. Unsolicited ratings occur more frequently. In these situations, no obligation is freely assumed by the parties. As a consequence, the applicable law must be determined under the Rome II Regulation. Its impact is much more problematic, and therefore needs closer scrutiny.

The Rome II Regulation does not feature any specific conflicts rule for financial torts. Therefore, the applicable law will have to be determined in accordance with Article 4 Rome II. Under its first section, the governing law is that of the country ‘in which the event giving rise to the damage occurred’. In case of economic loss caused through financial intermediaries, this country is not easy to identify. Different solutions have been suggested.


102 See Art. 3(1) Rome I Regulation.
Some authors argue that the victim of a financial tort ultimately suffers the economic loss at his home, considered as the ‘centre of patrimony’. They therefore suggest applying the law of his habitual residence. However, this approach has been explicitly discarded by the ECJ. In *Kronhofer*, the court ruled that the habitual residence of the investor could not be taken into consideration when determining the place where the harmful event occurred under Article 5 No. 3 of the Brussels Convention. Because of case law and statutory requirements, this reasoning has to be transferred to the Rome II Regulation.

Another suggestion is to apply the law of the country in which the rated issuer has its seat. It has been claimed that the liability claim would have the closest connection to this country. However, this view is not entirely convincing. The current EU conflicts regime refers in principle to the place where the damage occurred, and only in exceptional cases to the law of the closest connection. While one could at least make an argument that an issuer suffers damage at its seat through a false rating, it is indefensible to locate the damage suffered by an investor at the place of the rated entity.

None of these suggestions can therefore hold. Following the letter of Article 4(1) of the Rome I Regulation, one must instead locate the direct damage. In this context, it is first necessary to carefully identify the damage suffered. Insofar, one has to distinguish between the damage done to an issuer, and that done to an investor. For the issuer, damage by an unjustified rating usually takes the form of a rise in its refinancing costs. This damage is suffered at the place of the market where the issuer refinances itself. One may also argue that the damage is suffered at the issuer’s seat. For the investor, damage consists of the loss of money paid for securities that are of less value than the rating suggests. This loss occurs in the bank account from which he has used to pay the cost of the instruments. The damage is therefore located in the country where this bank account is managed.

As a consequence, the applicable law will depend on the place where the investor’s bank account that supplied the money to pay for the securities is located. The result is a complete dispersal of the applicable law. The rating of instruments that have been sold to investors in different countries will be subject to many different rules. Even if instruments have been bought by the same investor, the applicable law may not be the same if he has paid for these instruments through various bank accounts in different countries.

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103 See e.g. B von Hoffmann, in Staudinger, *Kommentar zum BGB* (Sellier 2001), Art. 40 EGBGB, no 282.
107 See Art. 4(1), (5) Rome II Regulation.
Obviously, this result is irritating and arbitrary. It would make much more sense to apply the law of the country where the rated securities are traded on an exchange or have been acquired on the over-the-counter (OTC) market. These connecting factors are followed, for instance, in the United States. In Europe, the Italian Corte di cassazione has followed a similar method in the context of determining of jurisdiction for torts under the Brussels I Regulation. It suggests locating the damage at the place where the investor bought the falsely rated securities. Although ingenious, this solution only works where the investor buys shares directly on the exchange, which is extremely rare. Most investors buy their shares through an intermediary, and not directly on the exchange.

The situation under EU law is thus very unsatisfying because of the absence of a special rule for financial torts in the Rome II Regulation. Suggestions to change the current regime have been made, but have so far been ignored by the European legislator. We are thus stuck with the regulatory prescription of an unreasonable way to determine the law applicable to rating agency liability. The CRA does nothing to change this result, and even exacerbates it by subjecting key terms of its new cause of action to national law.

D. **Extraterritorial Reach**

Although all of the foregoing difficulties are important, they are superseded by another, even more fundamental problem. According to Article 2(1) of the CRA Regulation, the whole regulation only applies to credit ratings issued by agencies registered in the EU. It has therefore been concluded in the literature that only agencies registered in the EU are subject to civil liability under the Regulation. This means that the ‘big three’ rating agencies would effectively not fall under the regulation. All of them have their headquarters in the United States. Although Fitch Ratings has a second headquarters in the UK, it is not itself registered in the EU. Rather, this function is fulfilled by its subsidiaries in different Member States. The big three could thus never be sued under Article 35a CRA Regulation by a European or any other investor.

It is true that there may be victims with a claim against their subsidiaries that are established in Europe and registered there. But these subsidiaries are not much more than mere letterbox companies. Their main task is to endorse ratings issued

by their U.S. parent, i.e. to confirm compliance with EU law.\textsuperscript{114} The CRA Regulation does not require them to dispose of a particular amount of capital or of a guarantee by the parent company. In case of a massive damages claim, their financial resources will quickly be depleted. If the liability provision in the CRA regulation will only hit them and not their parent companies in the U.S., it would be nothing more than a paper tiger.

However, the restriction in scope is not as clear-cut as the argument just made suggests. It is possible to make several counter-arguments. One could underline that the legislator has expressed the wish to introduce a right of redress for investors who have reasonably relied on a rating, and for issuers who have suffered damage because of a credit rating.\textsuperscript{115} Investors usually rely on ratings by the U.S. agencies, and issuers are mostly damaged by these agencies’ ratings. It would be odd if they were not held responsible under the regulation. On a more technical level, one may note that the wording of Article 2(1) CRA Regulation speaks of ‘rating agencies’. This term is defined in Article 3(1)(b) CRA Regulation without any requirement of registration, or any reference to the place in which the agency is established, which suggests that the Regulation must also apply to third-country CRAs. One could try to corroborate this argument by underlining that some of the Regulation’s provisions indeed expressly apply to agencies that are not registered in the EU. A salient example is the duty to register,\textsuperscript{116} which by definition, can only be infringed by a CRA that is not (yet) registered. Another example is the rule on equivalence of ratings that emanate from third-countries contained in the Regulation.\textsuperscript{117} It would make no sense to consider ratings that emanate from agencies in third countries as ‘equivalent’ to European ratings under Article 5 CRA Regulation, and then not subject them to civil liability under the same act. Furthermore, one could underline that the registration requirement in the EU merely serves as a pre-condition for the use of the rating for regulatory purposes.\textsuperscript{118} With the introduction of rating agency liability, in contrast, the Commission pursues a much broader aim. It strives to cover all credit ratings “regardless of whether issued for regulatory purposes or not”.\textsuperscript{119} One may thus argue that the registration requirement should not be determinative for advancing private claims. Finally, imposing civil liability on U.S. rating agencies does not contravene principles of public international law. Limits on extraterritorial legislation are not violated so long as capital markets or investors in the EU are in fact damaged. Incidentally, it may be noted that the U.S. imposes the same liability on foreign rating agencies that assess securities listed on its exchanges or that trade in its territory.\textsuperscript{120}

\textsuperscript{114} See Art. 4(3) CRA Regulation.
\textsuperscript{115} Recital 32, sixth sentence Regulation 462/2013.
\textsuperscript{116} See Annex III No. 1 54 CRA Regulation.
\textsuperscript{117} Art. 5 CRA Regulation.
\textsuperscript{118} See Art. 4(1) CRA Regulation.
\textsuperscript{119} European Commission, COM(2011), 747 final, p. 11.
Despite the weight of these arguments, it remains that the legal situation is unclear.\footnote{In the same sense, N Nisi (n 111) 93, footnote 30.} The reason is the Regulation’s sloppy drafting. It would have been clearly preferable if the EU legislator had amended the definition of the scope of the CRA Regulation while introducing the new Article 35a. By failing to do so, it has created a procedural risk for investors and issuers. They will now have to ‘test drive’ the law in court to see whether the new liability regime applies against the big three U.S. rating agencies.

4. CONCLUSION

Rating agencies are important gatekeepers that wield significant economic power. The market alone is incapable of disciplining them. There is a need for civil liability where they commit grave mistakes during the rating process. Yet this liability must be restricted. It should only apply were agencies commit factual errors or violate their own methodology, and it should be restricted to grave or blatant errors. Arguments of freedom of speech do not stand in the way as long as the core of the assessment is left to the agencies’ discretion.

Other legal systems have drawn their lessons. The United States and Australia, each with their own particularities, support effective regimes that allow suits against rating agencies in cases of grave errors. In contrast, the legal situation in the European Union remains unsatisfying. The introduction of a special cause of action in the CRA Regulation did not help. By putting the definition of all key terms in the hands of the Member States, the new rule permits the continued application of different standards in the EU. It also fails to clearly identify the applicable law. Finally, it is not yet certain whether the new rule may even be used against U.S. rating agencies. One must thus conclude that the new EU regime leaves much room for improvement.