PREFACE

Over the last decade, credit rating agencies (CRAs) have given rise to a heated debate among academics, practitioners and their designated users (i.e. issuers and investors) about both the very idea of having a strong regulatory framework and how this would work in practice. The 2007–09 global financial crisis revealed that market participants did not understand either the powerful role played by CRAs in the capital markets or how the ratings industry affects the legal and economic aspects of financial regulation. For instance, CRAs failed to anticipate the seriousness of the bursting of the housing bubble in the US or to recognize the poor quality of the subprime loans packaged into securities. Further, the turmoil showed glaring shortcomings of CRAs in providing independent and accurate evaluations of the creditworthiness of firms and structured finance products (e.g., the Lehman Brothers and subprime mortgages cases).

It is argued that the present system for regulating CRAs in the US, the UK and the EU is defective in terms of information asymmetries, absence of transparency, conflicts of interest and limited competition. On this view, the analysis demonstrates that CRAs should be regulated having due regard to their potential systemic threat. The analysis also suggests that CRAs should be subject to professional standards similar to those applicable to other information intermediaries such as auditors and financial analysts. CRAs should be made responsible for their investment certification because of their fundamental role in the evaluation of credit risk and their influence on confidence and decisions in the market. It is evident that some individual investors are unskilled and make poor decisions about risk even when they have obtained full information about the products. In order to avoid failures on the part of CRAs, it is necessary that these agencies perform their role of promoting financial awareness while being accountable for their opinions, since they are more than simple opinion providers.

In this context, the liability regime of CRAs in the financial markets and the implications of CRAs’ business activities for market participants represents the crux of the matter for regulators. CRAs’ activities influence not only investor behaviour but also the stability of financial markets. CRAs have the power to label bonds for issuance firms. They act as ‘gatekeepers’ by regulating the flow of market-sensitive information. As a result, credit ratings became a crucial reference for the banking and financial system, playing a ‘certification’ role that has created conflicts of interest between CRAs and issuers, and high barriers to entry to additional competitors—while the CRAs enjoyed immunity from liability. Fair competition could reduce the phenomenon of ratings shopping and may reduce monopolistic or oligopolistic rents, and add information to financial markets since raters sometimes give different ratings. In this regard, there is a need to address the main problems in connection with CRAs’ modus operandi, namely: (1) the ‘issuer-pays’ business model; (2) over-reliance on ratings for regulatory purposes and on the part of investors; (3) limited competition; and (4) lack of accountability.

The critical aspect is that credit ratings affect market confidence and influence both investment decisions and expectations. As intermediaries, credit ratings should profit from warning investors because they manage ‘market information’, which is generally considered to be a public good. Through their trustworthy reputation they constitute suppliers of independent
information for investors. So there is a public interest in achieving accountability for this publication of results.

It is important to assess the extent to which CRAs may be held liable for issuing inaccurate ratings. In particular, the legal reasoning by which liability might attach to a CRA and identifies the parties who might have a claim and the nature of the damages that might be recovered. CRAs are to be blamed for misjudging the safety of securities products which ultimately proved toxic for banks and investors. CRAs need to be held accountable but the existing regulatory framework does not secure adequate protection for market participants. Although several legislative reforms have been adopted globally, there is a strong argument that lack of rules of the game is the major factor in the accountability regime of CRAs. The problem is made worse by the fact that investors find it difficult to choose the right financial product because there is no appropriate system of disclosure and the internal control rules are inadequate. Market participants mechanistically rely on ratings, thus causing hazardous behavior such as sell-offs of securities when they are downgraded, the so-called ‘cliff effects’, that can determine procyclicality and systemic risk.

With regard to the liability regime, discussion of the role of private-law remedies has the benefit of analysing the difficulties posed by private litigation in different jurisdictions and clarifying the legal reasoning by which liability might attach to a CRA. It would also have the benefit of explaining the link between the systemic impact of CRAs’ activities on financial stability and the private-law framework applicable to CRAs.

The public interest in maintaining financial stability and the enforcement function of a private liability regime are directed to securing protection for retail investors. The flexibility of private law may contribute to pressing regulatory objectives for CRAs such as transparency and market integrity, and may assist the regulatory authorities in identifying the risks of ratings. Recently, the role of the courts in the private law aspects of financial law has been predominantly considered with reference to the crisis-era experience. In particular, private-law actions have been widely used to contain systemic risk in the case of financial failures, and to address the costs of damages in the case of compensation for losses. The relative merits of private disciplining techniques are essentially to provide quick solutions in complex and time-pressured circumstances through contractual clauses or court decisions.

The ‘estoppel’ doctrine, particularly estoppel by representation (or estoppel by conduct) could be invoked against CRAs in order to protect investors’ expectation interest. If estoppel is used to protect persons who reasonably and detrimentally rely on the representations of others, CRAs should owe a duty to take reasonable care that the statement is correct. However, it is a difficult task for investors to show that their expectations were affected by inaccurate ratings at the time when the investment decision was taken. Once the representation has been acted on to the detriment of the transferee the contrary may not be asserted. Estoppel by representation may be applied where CRAs might seek to deny their evaluations in case of faulty ratings. Further, estoppel by representation may be used by the investor as a viable argument to defeat a plea by the CRA that there is no contractual relationship between it and the investor; and to prevent the CRAs from claiming that a rating is a mere opinion about the creditworthiness of financial products. Estoppel is not used for the direct enforcement of promises or representation of facts. Consequently, estoppel cannot by itself entitle a claimant to a remedy for a factual situation. This means that estoppel cannot be used to obtain a remedy for a misstatement. The estoppel rule with its features and limitations might not be a feasible way of making CRAs accountable because of its limitations as an equitable shield rather than a sword; however the estoppel rule could be treated as a deterrent for CRAs’ misstatements.

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As mentioned, CRAs are capable of bringing about potential distortions in the financial sector, thereby resulting in a reduction in market confidence which, in turn, influences negotiations and expectations. In this context, a civil liability regime for CRAs could constitute a system of investor protection over and above traditional regulation. This scholarship will go some way to plug the gap in the knowledge and understanding of the most salient issues related to the use of CRAs, through the production of an innovative, international and interdisciplinary work which links both the law and policy surrounding financial markets regulation.

In summary, the work provides a comprehensive coverage of issues in the areas of: (1) systemic risk; (2) market failure; (3) sovereign default; and (4) financial disclosure. In addition, it addresses issues that are intimately related, such as reputational capital, investor protection, the gatekeeper function and regulatory licenses.

The first part sets the context of the analysis by exploring the main features of the ratings industry taking into consideration the major problems involving CRAs. The increasing influence of CRAs in the securities sector and their operations—with particular emphasis on certain drawbacks in the current regulatory framework—as well as the long-standing problems associated with the CRAs’ activities are examined.

This part focuses on the reliability of CRAs since this has been questioned following the mis-evaluation of the default risk attaching to certain financial products—such as subprime mortgages and derivatives—that adversely affected the stability of securities markets. It is discussed how CRAs’ activities have exhibited a lack of proper due diligence and a deficiency in their assessment of corporations’ creditworthiness. This part also shows that CRAs exhibit potential conflicts of interest because they have a financial incentive to accommodate the preferences of bond issuers owing to the fact that they are selected and paid for by them. It discusses the ‘certification role’ of CRAs, with particular attention given to criticisms of the ratings market. In this context, account is taken of the function of ‘rating triggers’ and the major problems regarding their use in financial contracts. The role of rating triggers in financial transactions is examined by considering the main criticisms of the effects of such clauses on market participants (such as the lack of disclosure of contract triggers). The problem of over-reliance on credit ratings is also addressed by considering the possible presence of ‘unhelpful’ incentives in the CRA industry. Moreover, the question of free-market interference is discussed in terms of facilitating a systematic dependence on ratings and favoring an artificially high demand for highly rated financial instruments.

The second part of the work analyses regulatory reforms relating to CRAs that have been adopted in the US, the UK and the EU. It imparts the major concerns associated with the CRAs’ assessment activity. In particular, it is contended that government initiatives have restored the transparency and fairness of CRAs by creating a rigorous system of regulation and supervision. However, the success of these regulatory measures is disputed. In considering CRAs’ failures and remedies, this part provides suggestions for strengthening the current legal framework of CRAs. This analysis demonstrates a persistent gap in the supervision and enforcement of CRAs’ activities: although the legislators have improved the monitoring system and increased the disclosure regime, the conduct of the main CRAs has remained unaltered.

Part III of the manuscript examines the implementation of the liability regime in the US, the UK and the EU (and also looks into Australia as important developments have taken place facing a revisit of the current status quo in other jurisdictions). The central idea is to hold CRAs liable for their erroneous ratings. This part explains why and how each system arrived at its own solution. In this regard, critical reflections are provided on Australian case law, namely the Bathurst judgment as well as an assessment of the civil liability regime for CRAs established by
the EU regulatory framework is provided. This part further discusses the legal reasoning by which liability might attach to a CRA and identifies the parties who might have a claim and the nature of the damages that might be obtained. The doctrine of 'equitable estoppel' is considered as a possible option to hold CRAs liable for inaccurate ratings together with an analysis of the liability scenario under the law of tort. The last part provides conclusive observations on the main findings of the research.

Overall, the book looks at the governance of ratings in connection with the liability of CRAs in the financial markets and the implications of CRAs' activities for regulators and investors. Particular emphasis is devoted to the CRAs' business model, underlying the potential collusive behavior between issuers and raters. Further, this book addresses the issues of inaccurate ratings methodologies, conflicts of interest and CRAs' ownership, since all these issues raised concerns about the lack of transparency and limited competition in the ratings industry.