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01 November 2012

Jonathan Faull
Director-General
Directorate-General Internal Market and Services
European Commission
1049 Brussels
Belgium

Dear Mr Faull

Issue 169: Regulation of Credit Rating Agencies

As you know, the remit of the Financial Markets Law Committee (the "FMLC" or the "Committee"), established by the Bank of England, is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.[1]

The FMLC is of the view that serious legal uncertainty would arise from the implementation of certain provisions concerned with civil liability which are contemplated in the proposal for, and various drafts of, the new Regulation on credit rating agencies ("CRA III"). As is explored below, the Committee has concerns with regard to, in particular, the reversal of the burden of proof on claimants.

The FMLC has already set out concerns with respect to the civil liability provisions in the Commission's proposal for CRA III in a letter dated 12 March 2012. Please find this letter enclosed.[2] The Committee welcomes the development of compromise texts in the Council which appear to address, to some extent, concerns raised in that letter.[3] Notwithstanding this, in the context of continuing trilogues regarding CRA III, the Committee believes it important that its concerns with regard to the reversal of the evidential burden be reiterated. The FMLC notes, in particular, that the Final Report of the ECON Committee retains the reversal of the burden of proof.[4]

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[1] The FMLC is grateful to Helen Carty (Clifford Chance LLP) and Ruth Fox (Slaughter and May) for their comments on this letter.

[2] You may be interested to know that in due course after publication, FMLC letters and papers are available for download at http://www.fmlc.org/Pages/papers.aspx.

[3] See, most recently, Council General Approach dated 25 May 2012.

[4] See ECON Report dated 23 August 2012.

Article 35a(4) of the Commission's proposal for CRA III provides that with respect to claims made pursuant to Article 35, if the claimant can establish facts from which "it may be inferred" that an infringement of CRA III has occurred, the burden of proof is reversed from claimant to defendant. In other words, it will not be necessary for the claimant to prove that the defendant has infringed the Regulation; it will be for the rating agency to prove that it has not breached the regulation.

It is not the role of the FMLC to take a view on the policy underlying proposals for the reversal of the burden of proof. The Committee believes, however, that a reversal of the evidential burden in the area of credit rating represents a challenge to a concept of law fundamental to many, if not all, legal systems in Europe. (The general position under English law, for example, is captured by the phrase "he who asserts must prove".) The provisions in proposals for CRA III represent, therefore, a considerable departure from established principle and practice at the national and European level.

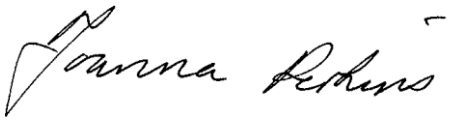
The FMLC believes that the reversal can, as a result, be expected to increase uncertainty as to the outcome of litigation and as to the operation of the law in general. In the view of the Committee, this could have a material negative impact on the wholesale financial markets. The FMLC is concerned, in particular, that it will become more difficult to obtain clear and definitive legal opinions in this area.

The FMLC also acknowledges the concern, raised by certain market participants and representatives of public authorities, that the effect of the reversal of the burden of proof may be to incentivise speculative litigation, in particular by sophisticated, professional clients.[5]

I would be delighted to discuss the issues raised in this and the enclosed letter with you further. Do not hesitate to contact me should you wish to arrange a meeting or if you have any questions.

A copy of this letter has been sent to Maria Teresa Fabregas Fernandez, Head of Unit G3, DG Markt.

Yours sincerely



Joanna Perkins
FMLC Director

Enc: Letter dated 12 March 2012

[5] Verena Ross, Executive Director of the European Securities and Markets Authority, made reference to the incentives which might result from a reversal of the burden of proof in a speech available at http://www.esma.europa.eu/system/files/2012-32_0.pdf.

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12 March 2012

Mr Ugo Bassi
Head of Unit G3
Securities Markets
DG International Market and Services
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Dear Mr Bassi

FMLC Issue 169: Regulation of Credit Rating Agencies

The remit of the Financial Markets Law Committee (the "FMLC"), established by the Bank of England, is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

The FMLC has reviewed with interest the proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No. 1060/2009 on credit rating agencies ("CRA III"). It is of the view that the liability provisions contained in Article 35a, CRA III will, if implemented, give rise to legal uncertainties.

It is not the role of the FMLC to question the policy underlying these liability provisions. The FMLC believes, however, that the lack of specificity and clarity in these proposals—as to which further detail is provided below—could have a material negative impact on the wholesale financial markets. In particular, the Committee's concern is that the proposals may prove litigious and concomitantly make it harder for financial markets participants to obtain clear and definitive legal opinions. The FMLC believes it important, therefore, that these issues of uncertainty be addressed in the proposed legislation.

EU-wide civil liability regime

Article 35a effectively introduces an EU-wide civil liability regime for negligence by credit rating agencies. It does so by imposing a new cause of action on member states' legal systems and introducing concepts (such as "gross negligence") and principles (such as the reversal of the burden of proof) that may not be in line with established national civil liability laws or rules of procedure.

This Article 35a is qualitatively different to the general position under equivalent EU liability regimes which require that obligations are enforced in accordance with member states' civil

liability regimes.[1] The introduction of an EU-wide regime would thus likely lead to litigation regarding the nature and enforceability of rights conferred by Article 35a. Furthermore, the lack of convergence in member state legal systems is problematic in two senses: first, legal uncertainty will persist while each member state decides on its interpretation of the various aspects of the regime; and secondly—in the absence of any provision in CRA III to address matters such as limitation periods, rules of evidence and quantification of loss—both procedure and substantive law and regulation are capable of producing materially different outcomes in otherwise identical circumstances.

Standard of negligence

Article 35a(3) provides that a credit rating agency may have an action brought against it if it has demonstrated "gross negligence". There is, however, uncertainty as to the meaning of "gross negligence". Article 35a(3) states that "a credit rating agency acts with gross negligence if it seriously neglects duties imposed upon it by this Regulation". However, no guidance is given as to what constitutes a "serious neglect" of duties. A failure to define clearly the standard of negligence required under this Article is likely to lead to uncertainty that will persist until the term has been interpreted by the courts. The term may also be interpreted differently across member states which could lead to a divergence in regulatory standards across the EU.

Furthermore, the lack of clarity as to the exact scope of the "gross negligence" standard is exacerbated by the lack of precision in the formulation of credit rating agencies' obligations under CRA III.

Obligations of credit rating agencies

Article 8.7, CRA III requires that:

> *"...where a CRA becomes aware of errors in its methodologies or in their application it shall immediately: (a) notify those errors to ESMA and all affected rated entities; (b) publish those errors on its website; (c) correct those errors in the methodologies; and (d) apply the measures referred to in points (a) to (c) of paragraph 6 [of proposed Article 8]"*

As currently expressed, the FMLC is of the view that these obligations are far too vague and imprecise and thus likely to give rise to significant difficulties for agencies in their approach to compliance and risk management. The Article appears to capture minor errors and technical breaches, yet publication of failings in these circumstances may have a market destabilising effect disproportionate to the error. It is not obvious to the FMLC that this result—which gives rise to uncertainty about CRA III's application and effect—is within the legislative intent.

Scope of liability

Article 35a(1) will, in effect, mean that credit rating agencies could be held liable to any investor who can demonstrate reliance on a credit rating. It does not appear that there is any requirement for "reliance" so demonstrated to have been reasonable. On this basis, and while it is not for the FMLC to comment on policy, the FMLC is of the view that the wide scope of these liability provisions is likely to invite litigation.

Limitation of liability

Article 35a(5) provides that credit rating agencies are prohibited from limiting their liability against third parties. The FMLC notes that the right to limit liability against third parties is generally accepted, as regards agreements between commercial actors, in most jurisdictions (including under English law). The ability to limit liability in this way is considered to increase contractual certainty. Article 35a(5) therefore appears to run contrary to the general tenor or thrust of member states' existing legal regimes and may have the effect of reducing contractual certainty.

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[1] See the UCITS Directive (Directive 2009/65/EC), the Prospectus Directive (Directive 2003/71/EC) or the Transparency Directive (Directive 2004/109/EC).

This provision also raises questions as to the scope of the proposed prohibition and its effect on indemnities or warranties in client agreements or terms of business. In the event of an investor claim under Article 35a, it is not clear that ratings agencies would continue to be able to rely upon these provisions.

Inversion of burden of proof

Article 35a(4) provides that the burden of proof is reversed from claimant to defendant (credit rating agency) in claims made under Article 35 if the claimant can establish facts from which "it may be inferred" that an infringement of CRA III has occurred. The FMLC notes that the inversion of the burden of proof is not in line with the general legal principles of European law or member states' law. It may also represent an incentive for speculative litigation by claimants.[2]

The provision does not define by whom an inference must be made nor does it make clear the nature of the inference necessary. On this basis, the Committee notes that Article 35a(4) does not require the inference to extend to the credit rating agency having committed the specific infringement either intentionally or with gross negligence, although these elements are required if the infringement is to be actionable. Further clarity is therefore required as to whether any inference made must include evidence of an intentional or grossly negligent infringement on the part of the credit rating agency.

Moreover, Article 35a(4) does not define the degree of confidence in an "inference" that is required to reverse the burden of proof. Recital 26 refers to an investor making a "reasonable case in favour of ... an infringement". In the view of the FMLC, however, this does not provide sufficient guidance to either agencies or investors with regard to the strength of the required inference.

Recital 27

Finally, Recital 27 states that "matters concerning the civil liability of a credit rating agency...which are not covered by this regulation...should be governed by the applicable national law". In the absence of further guidance, this recital gives rise to uncertainty as to which matters are not within the scope of CRA III. Litigation regarding the question of whether issues fall under CRA III may result from this uncertainty.

Article 6b (Mandatory Rotation Requirement)

While this letter is predominantly concerned with the harmonised civil liability framework proposed by CRA III, the FMLC considers that the mandatory rotation requirement—contained in Article 6b, CRA III—is of significant concern. As noted above, the FMLC's remit is to provide recommendations to resolve legal uncertainty; the Committee does not ordinarily engage with the economic impact of legislative proposals. However, it is also aware that other neutral public agencies have expressed their disquiet on the subject of this requirement and therefore, on this occasion, the Committee feels bound to express its concern about the possible introduction of operational uncertainty.

Article 6b provides for a mandatory rotation requirement for credit rating agencies in the context of issuer-pays ratings arrangements. The engagement of a credit rating agency would be limited to a period of three years or, if a rating agency rates more than ten consecutive debt instruments of the issue, to a period of one year. Furthermore, the proposals impose a "cooling off" period of four years and stipulate that the outgoing agency must produce a "handover file". The practical implications of this remain unclear. In order for it to be possible to comply with the rotation requirement, more credit rating agencies will have to be introduced to the market. As has been acknowledged by ESMA,[3] the effect of such forced competition may be a reduction in the quality of ratings since new entrants may lack

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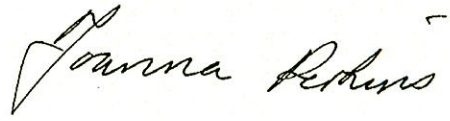
[2] Verena Ross, Executive Director of the European Securities and Markets Authority, made reference to the incentives which might result from a reversal of the burden of proof in a recent speech. The speech is available at http://www.esma.europa.eu/system/files/2012-32_0.pdf.

the experience and technical competence (at least in the short term) required to meet the expectations of the market. It is self-evident that, if the reliability of credit ratings is undermined and/or mandatory rotation gives rise to a fluctuating sequence of widely divergent ratings for the same institution, this could have significant implications for the stability of the financial markets.

I would be delighted to discuss the issues raised in this letter with you further. Do not hesitate to contact me should you wish to arrange a meeting or if you have any questions.

Yours sincerely



Joanna Perkins, Director

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[3] Ibid.