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China's Emerging Credit Rating Industry: Regulatory Issues and Practices

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ABSTRACT:

Accompanying the great development of the bond market over the last decade, China's emerging credit rating industry has entered a rapid growth stage. This paper will seek to review legal issues of China's credit rating agencies from the perspective of comparative studies. Part I gives an overview of two main stages in the development of this emerging industry. Part II and Part III examine major issues in the debt ratings debate, such as conflict of interests, enhancing competition and regulatory reform. Part II first compares the advantages and disadvantages of various pay models for CRAs, including the dominant issuer pays model and alternative pay models; then it discusses how regulation affects competition and business activities of credit rating agencies (CRAs) and related regulatory reforms in the U.S. and EU. Part III examines the barriers, and causes of action concerning CRA liability through some significant cases, such as *County of Orange v. McGraw Hill Cos*, *Jefferson Cty. Sch. Dist. No. R-1 v. Moody's Investors, Inc.*, and *Abu Dhabi Comm. Bank v. Morgan Stanley & Co.* in the U.S. Part IV reviews the characteristics of four major Chinese CRAs. Part V examines the multiple regulatory system and two self-regulatory organization for credit rating industry. Part VI discusses a series of legal issues in the Chinese context, such as the current issuer pays model and conflicts of interest arising from it, , reputational mechanism, rating shopping, market access, independence of CRAs and accountability of credit ratings, as well as a recent case concerning ratings of peer-to-peer lending platform. Finally, it concludes that the forthcoming financial system reform will change the multi-regulator system.

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[ABSTRACT]

Accompanying the great development of the bond market over the last decade, China's emerging credit rating industry has entered a rapid growth stage. This paper will seek to review legal issues of China's credit rating agencies from the perspective of comparative studies. Part I gives an overview of two main stages in the development of this emerging industry. Part II and Part III examine major issues in the debt ratings debate, such as conflict of interests, enhancing competition and regulatory reform. Part II first compares the advantages and disadvantages of various pay models for CRAs, including the dominant issuer pays model and alternative pay models; then it discusses how regulation affects competition and business activities of credit rating agencies (CRAs) and related regulatory reforms in the U.S. and EU. Part III examines the barriers, and causes of action concerning CRA liability through some significant cases, such as County of Orange v. McGraw Hill Cos, Jefferson Cty. Sch. Dist. No. R-1 v. Moody's Investors, Inc., and Abu Dhabi Comm. Bank v. Morgan Stanley & Co. in the U.S. Part IV reviews the characteristics of four major Chinese CRAs. Part V examines the multiple regulatory system and two self-regulatory organization for credit rating industry. Part VI discusses a series of legal issues in the Chinese context, such as the current issuer pays model and conflicts of interest arising from it, , reputational mechanism, rating shopping, market access, independence of CRAs and accountability of credit ratings, as well as a recent case concerning ratings of peer-to-peer lending platform. Finally, it concludes that the forthcoming financial system reform will change the multi-regulator system.

[Key Words] Credit Rating Agency (CRA); Issuer Pays Model; Investor Pays Model; Rating Shopping; "Reputation Hypothesis"; Multiple Supervisory System; CRA Liability; Double Ratings; Inter-bank Bond Market; Exchange Bond Market

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A. China's Emerging Credit Rating Industry

The development of China's credit rating industry has experienced a few stages. At the very beginning, it developed slowly. In February 1988, Shanghai Fareast Credit Rating Co., Ltd. was founded as the first credit rating agency with the approval of the PBOC Shanghai Branch. The State Economic and Trade Commission and PBOC approved the establishment of China Chengxin and Dagong Global in 1992 and 1994 respectively. In 1997, the PBOC accredited nine CRAs the qualification of national credit ratings.¹ In 1999, China Chengxin International Credit Rating Co., Ltd. became the first joint-venture CRA in China. In the 1990s, a few CRAs such as the China Lianhe Credit Rating Co., Ltd., China Cheng Xin International Credit Rating Co. Ltd., Dagong Global Credit Rating Co., Ltd., Shanghai Brilliance Credit Rating & Investors Service Co., Ltd., and Pengyuan Rating Co., Ltd. were founded.

1. Early Stage of Credit Rating Industry and Segmented Bond Markets

The growth of China's credit rating industry is related to the development of China's bond market. In March 1987, the State Council enacted the *Interim Regulation on Administration of Enterprise Bonds*, which established the issuance and administration system for state-owned enterprises (SOEs) to issue enterprise bonds. The 1987 regulation stipulates that the PBOC, Ministry of Finance (MOF) and the State Planning Office shall work out the annual quota of enterprise bond issues for the country as a whole and proceed at the province level.² In 1993, the State Council enacted the *Regulation on Administration of Enterprise Bonds* to promote the enterprise bond market. The 1993 Regulation continued the approval system of annual quota and the PBOC, MOF, State Planning Office and the State Council Securities Commission formulated the annual quota for issuing enterprise bonds.³

The allocation of approval system of bond issues decide by the State Council in 1992 is as follows: (a) The Ministry of Finance is in charge of government bonds; (b) The PBOC

¹ See the PBOC *Yin Fa* [1997] No. 547.

² Article 12 of the *Interim Regulations on Administration of Enterprise Bonds* issued by the State Council on March 27, 1987 and replaced by the *Regulations on Administration of Enterprise Bonds* on August 2, 1993.

³ Articles 10 and 11 of the *Regulations on Administration of Enterprise Bonds* issued by the State Council on August 2, 1993 and amended on January 8, 2011.

approves financial bonds and investment securities bonds; (c) The State Planning Office approves state investment bonds and state investment corporate bonds; (d) The PBoC and the State Planning Office approve central state-owned enterprise bonds; (e) Local government bonds are approved by the provincial governments or governments of cities specifically designated in the state plan.⁴ The framework of separate operation and separate regulatory system produced the following two bond markets:

	Inter-bank Bond Market	Exchange Bond Market
Market Participants	Commercial banks are the major market player; Other participants include non-bank financial institutions, enterprises and public institutions. Not open to individuals	Non-bank financial institutions, non-financial institutions and individual investors.
Traded Bonds	Government bonds; Enterprise bonds; ⁵ Policy financial bonds; Central bank bills; ⁶ Commercial papers; ⁷ Medium-term notes ⁸	Government bonds; Enterprise bonds; Corporate bonds ⁹
Self-regulatory Organization	National Association of Financial Market Institutional Investors (NAFMII)	Securities Association of China (SAC)
Regulator	The People's Bank of China (PBoC)	China Securities Regulatory Commission (CSRC)
Yield Rate of Bonds	Relatively low yields with higher market liquidity	High yields with lower liquidity ratio

In the mid-1990s, enterprise bond default rate continuously rose. By the end of 1997, default risks piles up to nearly CNY 3 billion; in Liaoning Province and Jilin Province, default rate

⁴ Article 2.2 of the *Notification on Further Strengthening Macro-economic Management of Securities Market* issued by the State Council on December 17, 1992.

⁵ The issuance of enterprise bonds is approved by the NDRC. "Enterprise bonds" refer to "the negotiable securities issued by enterprises in accordance with legal procedures, and on which such enterprises agreed to pay principals and interests within a certain period." See Article 5 of the *Administrative Regulations on Enterprise Bonds* issued by the State Council on August 2, 1993 and amended in 2011.

⁶ Central bank bills are issued based upon the *Interim Measures of the PBoC for the Administration of Financial Bills* (1993).

⁷ "Commercial papers" refers to "debt financing instruments agreed to repay principal and interest within one year issued by non-financial enterprises (hereinafter referred to as the enterprises) with legal person qualification in the inter-bank bond market". See Article 2 of the *Guidelines for Commercial Paper Business of Non-financial Enterprises in the Inter-bank Bond Market* issued by the NAFMII on April 15, 2008.

⁸ "Medium-term notes" refer to "debt financing instruments agreed to repay principal and interest in a certain term issued by phases according to the plan by non-financial enterprises (hereinafter referred to as the enterprises) with legal person qualification in the inter-bank bond market". See Article 2 of the *Guidelines on Medium-term Notes Business of Non-financial Enterprises in the Inter-bank Bond Market* issued by the NAFMII on April 16, 2008.

⁹ The issuance of corporate bonds is approved by the CSRC. "Corporate bonds" refer to "marketable securities issued by a company pursuant to statutory procedures whose principal plus interest shall be serviced within a specific time limit as agreed upon". See Article 153 of the *PRC Company Law* (2014 amendment).

was even above 50%.¹⁰ In 1998, the PBOC enacted the *Administration of Issuance and Transfer of Enterprise Bonds* and required that enterprises should provide guarantees when issuing bonds, except those approved by the PBoC to be exempted from such guarantee requirement.¹¹

Meanwhile, the government took various measures to solve the credit default problems. In order to enhance the approval system of bond issuance, the issuers must be qualified for certain criteria and provide guarantee from commercial banks. In the inter-bank bond market, the PBC issued *Rules on the Issuance of Subordinated Bonds by Commercial Banks* in June 2004, which allowed commercial banks to hold subordinated bonds issued by other banks capped by 20% of their core capital.¹² In 2003, the NDRC took the place of the State Development and Planning Committee¹³ in the administration of enterprise bond issues. As a result of the strict approval system and “rigid redemption”, the default risk from 1998 to 2006 kept in a quite low rate.¹⁴

In the 1990s, there were very limited bond products and the default rate was low. From 2001 to 2004, Chinese CRAs only issued ratings for 60 bonds, whose issue volume was less than CNY 150 billion.¹⁵ Therefore, the market for credit ratings was limited at that time.

2. Rapid Development after 2005

The year of 2005 is an important turning point for both Chinese credit rating industry and bond market. The turning point is that the NDRC decided to boost the enterprise bond market. Later, the emergence and rapid development of Subordinated debts of Commercial banks, non-policy financial bonds, commercial papers, asset-backed securities and medium-

¹⁰ Libo Tao, “Analysis on the Defaults in the Chinese Bond Market” (4 April 4 2014) *Sina Finance*, available at: <http://finance.sina.com.cn/money/bond/20140404/135818715164.shtml>.

¹¹ See Article 3 of the *Administration of Issuance and Transfer of Enterprise Bonds* issued by the PBoC on April 1, 1998 and became invalid on August 17, 2000.

¹² Article 13 of the *Rules on the Issuance of Subordinated Bonds by Commercial Banks* issued by the PBOC on June 17, 2004.

¹³ The State Planning Office became the State Development and Planning Commission in 1998 in the restructuring of the State Council. In the 2003 restructuring of the State Council, the National Development and Reform Commission (NDRC) took the place of the State Development and Planning Committee together with the previous State Economic Restructuring Office and part functions of the State Economic and Trade Commission.

¹⁴ Jianjian Lin, “How Does the Expectation for Rigid Redemption Come into Being?” (12 November 2005), available at: <http://wallstreetcn.com/node/226000>.

¹⁵ Bing Guo and Xu Zhang, “The Development and Suggestions on China’s Credit Rating Industry of Bond Market” (October 2012) *China Bond*, pp. 14-19.

term notes greatly boosted the inter-bank bond market and the exchange market, and thus promoted the progress of credit rating industry.

In May 2005, the PBOC allowed qualified financial institutions to underwrite or sell an enterprise's short-term financing bonds in the National Inter-bank Bond Market under an agreement.¹⁶ In 2005, 79 short-term financial bonds were issued and their issue volume reached CNY 142.4 billion. From 2005 to 2012, the emergence of a large number of short-term financial bonds, commercial papers and medium-term notes (MTNs) promoted the credit rating industry; Chinese CRAs issued ratings for 6,155 bonds, of which short-term financial bonds and medium-term notes occupied 62.15%.¹⁷

In January 2008, the NDRC enacted NDRC Finance [2008] No. 7, which allowed enterprises to issue unsecured bonds, asset-backed bonds and third-party secured bonds.¹⁸ Considering the risk of off-balance sheet, the CBRC required commercial banks gradually quit from guarantee of project-based enterprise bond issues and forbid commercial banks of providing guarantees for new bond issues. After 2008, the NDRC no longer required financial guarantee for enterprise bond issues. Thereafter, the proportion of secured bonds decreased year after year. By 2013, the proportion of secured bonds was less than 10%.¹⁹

At the same time, China's credit rating industry started to grow. In 2005, China's bond market started its rapid development. In order to introduce advanced management and methodology, Chinese CRAs sought to establish joint ventures or cooperation with the "Big Three": Moody's owns 49% shares of China Cheng Xin International Credit Rating Co., Ltd.; Fitch owns 49% of China Lianhe Credit Rating Co., Ltd.; Shanghai Brilliance Credit Rating & Investors Service Co., Ltd. has technological cooperation.

Aside from domestic strategies, Chinese CRAs have strived for internationalization. In 2003, Shanghai Far East Credit Co. joined the ACRAA. Six Chinese CRAs, including China

¹⁶ See Articles 2 and 3 of *Operating Procedures for the Underwriting of Short-term Financing Bonds* issued by the PBOC on May 23, 2005 and nullified on April 15, 2008.

¹⁷ Bing Guo and Xu Zhang, "The Development and Suggestions on China's Credit Rating Industry of Bond Market" (October 2012) *China Bond*, pp. 14-19.

¹⁸ Article 3 of the *Notification on Promoting the Development of Enterprise Bond Market and Simplifying Related Items of Approval-based Issuance Procedure* issued by the NDRC on January 2, 2008.

¹⁹ Jianjian Lin, "How Does the Expectation for Rigid Redemption Come into Being?" (12 November 2005), available at: <http://wallstreetcn.com/node/226000>.

Chengxin, China Lianhe, Dagong Global, Shanghai Brilliance Rating, Golden Credit Rating International Co., Ltd. and Shanghai Far East Credit Rating Co., Ltd. (SFECR), have become members of the Association of Credit Rating Agencies in Asia (ACRAA).²⁰ The credit rating business stepped into a stage of stable development. In 2011, the market share of credit rating business among five CRAs in China's inter-bank bond market and exchange bond market was as follows:²¹

	Dagong Global	China Lianhe	Shanghai Brilliance	China Chengxin	Pengyuan
CPs	17.05%	30.49%	10.66%	35.90%	0.00%
MTNs	22.12%	31.76%	16.00%	30.12%	0.00%
Enterprise Bonds	25.79%	17.89%	11.58%	18.42%	26.32%
C-Bonds	8.70%	22.83%	9.78%	44.57%	14.13%
Financial Bonds	12.12%	45.45%	6.06%	36.36%	0.00%
In Total	19.19%	28.96%	12.30%	32.22%	4.67%

As of August 13, 2015, on the list of 97 world rating organizations in 44 countries, among the four Chinese CRAs including the Chengxin International Credit Rating Co., Ltd., China Lianhe Credit Rating, Co. Ltd., Dagong Global Credit Rating and its overseas branch in Italy - Dagong Europe Credit Rating, S.r.l. and Shanghai Credit Information Services Co., Ltd. (CIS), the Dagong Europe Credit Rating, S.r.l. was the only CRA recognized by ESMA. Other Chinese CRAs are not recognized by SEC, European Securities and Markets Authority (ESMA) and Swiss Financial Market Supervisory Authority (FINMA).²²

B. The Debt Ratings Debate and Related Regulatory Reform on CRAs

Inadequate or incorrect ratings by the CRAs produced significant losses and were a substantial component of the 2008 global financial crisis. The "Debt Ratings Debate" is mainly focused a few aspects: (a) Conflicts of interest arising from the issuer pays model; (b)

²⁰ Refer to the website of ACRAA, <http://acraa.com/acraamembers.asp>.

²¹ Zhijun Zhang, "Current Situation, Problems and Suggestions of China's Credit Rating Industry" *China Securities*, 2013, Vol. 1, pp. 76-80, available at: http://www.sac.net.cn/yjcbw/zgzqzz/2013/2013_01/201303/P020130305625862220700.pdf. The data are originally from WIND database.

²² Wikirating, "List of Credit Rating Agencies" (13 August 2015), available at: http://www.wikirating.org/wiki/List_of_credit_rating_agencies.

Enhancing competition and reputational mechanism of credit rating industry; (c) Accountability of credit ratings; and (d) CRAs' liability of false ratings.

1. The Debt Ratings Debate

Credit Rating Agencies (CRAs) have been regarded as one of the industries which are account for the global economic downturn. The debt ratings debate after the subprime crisis of 2007 discussed the effectiveness of the credit rating system and raised questions such as whether the failure of ratings had been “a result of a potential conflict of interest and/or a lack of competition in the industry”.²³ For example, rating agencies gave triple-A ratings to 75% of the \$3.2 trillion subprime mortgages that lost sizable value only months after the ratings were made.”²⁴ As a result of the role of CRAs in the recent financial crisis, reform of CRAs has been widely debated and considered. The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in July 2010, included CRA reform.²⁵

1. Pay Models

There are significant conflicts of interest that exist in the issuer pays model, with plenty of anecdotal evidence to suggest the theoretical problems transcend the barrier to reality, and a more limited body of empirical evidence confirming the same. Alternative payment models have advantages and disadvantages:

Pay Models	Advantages	Disadvantages
<u>Issuer Pays Model</u> Securities issuer pays the credit rating	Widely used since 1970s; Ensures ratings available to the entire bond market	Resulted in conflicts of interest; CRAs may compromise on profits at the cost of quality of ratings
<u>Investor Pays Model</u> Investors or subscribers pay the credit rating	CRAs feel independent of issuers; Partly avoids problems of conflicts of interest;	Increases the cost of investment risked and thus reduces demand for securities; Reduces the independence of CRAs;

²³ Chris Henderson, “The Debt Ratings Debate” (28 February 2008), available at: <http://www.investopedia.com/articles/bonds/08/ratings-agencies.asp>.

²⁴ Paul Krugman, Op-Ed, “Berating the Raters” (25 April 2010) N.Y. TIMES, (targeting CRAs).

²⁵ *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111–203, 124 Stat. 1872–90 (2010) (enacting “Subtitle C—Improvements to the Regulation of Credit Rating Agencies”, §§ 931–939H of the Dodd-Frank bill). For a review of recently enacted legislative and regulatory reforms for CRAs, see “New Developments in Securitization 2010: The Dodd-Frank Securitization Reforms, FDIC Safe Harbor Securitization Reforms and Rating Agency Reforms Panel”, 930 PLI/COMM 603 (. 2–3 December 2010).

<p>“Payment-upon-Results” Model CRAs’ payment depends on the accuracy of ratings</p>	<p>This model “could hold CRAs more accountable for the quality of their ratings”.²⁶</p>	<p>Hard to implement this model;</p>
<p>Public Utility Model This model suggests to establish a government managed CRA²⁷</p>	<p>Using the results of public CRA to check credit ratings issued by private CRAs</p>	<p>Concerns about expense; Increasing overreliance on rating results;</p>
<p>“Trading venues Pay” Model A joint model for issuer pays model and investor pays model</p>	<p>This alternative accommodates both issuer pays model and subscriber/investor pays model</p>	<p>Not covers large number of unlisted securities; Not favored by market participants and public authorities;</p>
<p>Hiring Agent Model A public or private utility or a SRO assigns NRSROs to determine the debt ratings.</p>	<p>This model tries to introduce a third-party agent to solve the problem of conflicts of interest</p>	<p>Concerns about costs; Hard to operate;</p>
<p>Blind, Pooled Issuer-Pay Model This model adjusts the traditional issuer-pay model by requiring issuers to pool the payments to CRAs, and provide these payments to an independent third-party who assigns a CRA to rate the issuer’s security.²⁸</p>	<p>“This model has the advantage of simultaneously solving (i) the free rider problem because the issuer still pays, (ii) the conflict of interest problem because the agency is chosen by the [assigning] body, and (iii) the competition problem because the [assigning body’s] choice can be based on some degree of excellence, thereby providing the rating agency with incentives to invest resources, innovate, and perform high quality work.”²⁹</p>	<p>Considering their limited number, CRAs may act as a whole and still favor issuers over investors in issuing ratings; May lead to more “homogenized”.³⁰</p>

The debt ratings debate has highlighted that the role of CRAs going forward is far from certain. Despite all of the outcry over the problems plaguing CRAs, clear solutions do not exist. There still do not appear to be any substantially viable solutions to resolving conflicts of interest that would not create additional problems or conflicts.

²⁶ Raquel Garc á Alcobilla and Javier Ruiz del Pozo, “Credit Rating Agencies on the Watch List: Analysis of European Regulation”, p. 251.

²⁷ European Commission, “Public Consultation on Credit Rating Agencies” (11 May 2010), available at: http://ec.europa.eu/internal_market/consultations/docs/2010/cra/cpaper_en.pdf.

²⁸ Senator Al Franken (D-Minn.), who introduced such a proposal as an amendment to the Senate version of the Dodd-Frank Act, called for the creation of a Credit Rating Agency Board to serve as a central clearinghouse for issuer’s seeking ratings. He argued that this proposal eliminates many of the conflict of interest concerns.

²⁹ Ibid. The *Dodd-Frank Wall Street Reform Act* requires the SEC to evaluate such a proposal, in conjunction with a Government Accountability Office study, and to accordingly enact regulations creating a Credit Rating Agency Board to serve as a central clearinghouse for issuer’s seeking ratings, unless the study suggests alternative action. *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111–203, 124 Stat. 1887–88 (2010) (§§ 939D–939F).

³⁰ See Kevin Drawbaugh & Andy Sullivan, “Senate Wall Street Reform Bill Hits Credit Raters” (13 May 2010), available at: <http://www.reuters.com/article/2010/05/13/us-financial-regulation-idUSWAT01445120100513>.

2. Enhancing Competition and Reputational Mechanism

Enhancing competition in credit rating industry is regarded as an approach to solve the problem of conflicts of interest, although increased competition can be a double-edged sword. On the one hand, increased competition may increase the likelihood that reputational considerations will be stronger. Thus, if competition is increased, reputation will carry more weight in the selection of a CRA for any particular security rating. Essentially, as one agency becomes sloppy, other agencies will pick up the slack and provide the reputation that brings value to the ratings sought by issuers. This makes a loss of reputation a more credible threat to revenues. Thus, through this form of the reputational mechanism, greater competition should lead to better practice.³¹

However, greater competition can lower the value of reputation, thus making it a weaker motivator. One motivating factor for developing a strong reputation is the ability to capture economic rents resulting from that reputation. As competition within the industry increases, however, these economic rents may diminish as agencies compete and lower ratings fees. Without the economic motivation to maintain reputation, and the cost of maintaining reputation in the form of greater analytical expenses and lost business, CRAs may have greater incentive to maximize short-term revenue at the expense of investors who rely on accurate ratings.³²

Greater competition increases the potential for agency shopping, which intensifies the prisoner's dilemma currently faced by CRAs. The adverse effect that competition has on the quality of ratings can be seen by the diminished quality of ratings that occurred when Fitch entered the market and issuer-friendly ratings became much more common place.

Thus, it is the relative bargaining positions of the CRAs, and the extent of competition in the industry that affects the conflict of interest problem. A market with only one CRA and

³¹ See Bo Becker & Todd Milbourn, "How Did Increased Competition Affect Credit Ratings?" (15 September 2010) *Harvard Business School Working Paper 09-051*, 1-3, available at: <http://www.hbs.edu/research/pdf/09-051.pdf>.

³² It is important to observe that not only are the investors, who rely on accurate ratings in making investment decisions, who benefit from CRAs maximizing their long-term interests (that is, producing accurate ratings). It is also the shareholders of the CRAs themselves who can be certain that their employees are acting in favor of the corporation. CRA shareholders want accurate ratings because it favors the CRA in the long term. For a discussion of the shareholders' interests, *see generally* Yu Flora Kuang & Bo Qin, *Credit Rating and CEO Risk-taking Incentives* (February 2009) (unpublished manuscript), available at: http://www.arw-suisse.ch/papers_tagung09/Kuang_Qin@Credit_Rating.pdf.

infinite issuers (each with an equal market share) will be a market bereft of the conflict of interest problem. A market with infinite CRAs and only one issuer will be a market with heightened conflict of interest problems.

3. Regulatory Reform in the United States

The regulatory system of CRAs in the United States has experienced a few stages. Prior to the establishment of “nationally recognized statistical rating organization” (NRSRO), self-regulation and reputational mechanism played a dominant role in the credit rating industry. In 1973, the SEC’s revised the “net capital” rule for broker dealers and the introduction of Rule 15c3-1 mandated balance sheet haircuts on values of securities in accordance with their respective credit ratings. In tandem, the SEC required that the credit ratings relied on must have been issued by a NRSRO, to avoid the enabling the creation of new CRAs specifically catering to issuers who were willing to pay for more favourable ratings.³³ This interplay became more profound over the years, and as of 2008, forty-four SEC rules and forms utilize credit ratings.³⁴ The securitization industry made use of a number of these; for example, issuers often relied on Rule 3a-7 of the *Investment Company Act of 1940* for an exemption for SPVs (from being regulated as an investment company) that issue fixed income securities with qualifying ratings from an NRSRO,³⁵ or the Form S-3 and F-3 conditions for shelf registration if the offering is deemed investment grade by an NRSRO.³⁶

Even before the global financial crisis, the role of CRAs was challenged. Professor Frank Partnoy of the University of San Diego School of Law has been one of the most vocal academic opponents of credit ratings, arguing that they provide very little informational value because of regulatory dependence on credit ratings and prohibitive barriers to entry for NRSROs.³⁷ Partnoy recommends less reliance on credit ratings, including the removal of explicit regulatory reliance on ratings and a regulatory “shock therapy” to jar market

³³ 17 C.F.R. § 240.15c3-1 (2009)

³⁴ Christopher Cox, Chairman, U.S. Sec. & Exch. Comm’n, Statement on Proposal to Increase Investor Protection by Reducing Reliance on Credit Ratings (25 June 2008), available at: http://www.sec.gov/news/speech/2008/spch062508cc_credit.htm.

³⁵ 17 C.F.R. § 270.3a-7 (2009)

³⁶ Rule 415 of the *Securities Act of 1933*, 17 C.F.R. § 230.415.

³⁷ See Frank Partnoy, “The Paradox of Credit Ratings” (Univ. San Diego Sch. of L., L. & Econ., Working Paper No. 20, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=285162.

participants from overreliance on ratings.³⁸ The Enron Event triggered the reform of ratings. Under the *Credit Rating Agency Reform Act of 2006*, small credit rating companies with three-year business performance are allowed to register as “statistical ratings organizations”.

The subprime mortgage crisis led to reactions to Regulatory Dependence on NRSROs’ ratings and the *Dodd-Frank Wall Street Reform Act* reduced over-reliance on rating results in regulatory activities. Section 939A of the *Dodd-Frank Act* requires regulatory agencies to remove references to credit ratings and instead use non-ratings standards of credit worthiness. In February, 2011, the SEC issued proposed rules to accomplish this mandate.³⁹ Many of the proposed rules were substantively similar to proposals released in 2008,⁴⁰ including a proposed rule change to shelf registration eligibility that illustrates the difficulties in finding alternatives to reliance on credit ratings.⁴¹

Quite clearly, determining how best to replace the use of credit ratings in the regulatory framework is far from resolved and no viable alternative has arisen. The possibility of using credit spreads has been discussed both in financial media and in academic literature.⁴² For instance, Partnoy argues that spreads, at minimum, provide the same information as credit ratings and are more accurate indications of credit quality. However, credit spreads are also indications of liquidity and psychology, which aren’t necessarily what we wish to measure.⁴³ Thus, despite the clamor to reduce regulatory dependence on credit ratings, it still appears to be the best of the available policy options.

³⁸ See Frank Partnoy, “Overdependence on Credit Ratings was a Primary Cause of the Crisis” (29 June 2009) FEEM Working Paper No. 27, available at <http://ssrn.com/abstract=1427167>.

³⁹ See “Summary of SEC Proposed Rulemaking: Security Ratings” (9 February 2011) Rel. Nos. 33-9186, 34-63874, available at: www.sec.gov/rules/proposed/2011/33-9186.pdf.

⁴⁰ Recognizing a problem of overdependence on third party ratings, in 2008 the SEC recommended removing reference to credit ratings in 11 of the rules, clarifying the regulatory purpose of reliance in 27 of them, and leaving only 6 as is. See Christopher Cox, Chairman, U.S. Sec. & Exch. Comm’n, Statement on Proposal to Increase Investor Protection by Reducing Reliance on Credit Ratings (25 June 2008), available at: http://www.sec.gov/news/speech/2008/spch062508cc_credit.htm.

⁴¹ See “Use of Credit Ratings in SEC Rules and Forms”, SULLIVAN & CROMWELL (18 February 2011), http://www.sullcrom.com/files/Publication/149133fd-145d-4b44-a39f-2656353c3d63/Presentation/PublicationAttachment/989f4dcd-288f-481a-88e5-275b917b2f0c/SC_Publication_Use_Credit_Ratings_SEC_Rules.pdf.

⁴² See Frank Partnoy, “The Paradox of Credit Ratings”, (Univ. San Diego Sch. of L., L. & Econ., Working Paper No. 20, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=285162, at 22.

⁴³ See Peter Rigby, “The Wishes of Crowds: Do Credit Spreads Measure Credit Risk?” S&P GLOBAL CREDIT PORTAL (13 December 2010), available at: <http://www2.standardandpoors.com/spf/pdf/fixedincome/TheWishesOfCrowdsDoCreditSpreadsMeasureCreditRisk.pdf> (as we would predict from a study released by S&P, concluding that using market prices as a proxy for credit risk is impractical).

4. Regulatory Reform in the European Union

In Europe, the European Commission's *Public Consultation on Credit Rating Agencies* examined the overreliance on external credit ratings, enhancing competition in the credit rating industry, potential conflicts of interest arising from the "issuer-pays" model, and the civil liability of CRAs.⁴⁴ EC 1008/2009 addresses the independence and integrity of CRAs (long-lasting relationships between CRAs and rated entities). For example, Article 6a "Conflicts of Interest Concerning Investing in CRAs" requires a shareholder or a member of a CRA holding at least 5% shares or voting right in that CRA or in a company which has control rights over that CRA, "shall be prohibited from: (a) holding 5% or more of the capital of any other CRA; (b) having the right or the power to exercise 5% or more of the voting rights in any other CRA; (c) having the right or power to appoint or remove members of the administrative or supervisory board of any other CRA; (d) being a number of the administrative or supervisory board of any other CRA; (e) exercising or having the power to exercise control or dominant influence over any other CRA."⁴⁵

In addition, Article 35a of EC 1008/2009 stipulates a CRA is liable for any intentional infringements or gross negligence listed in Annex III which has an impact on a credit rating.⁴⁶ The proof of evidence of an infringement is generally on the investor or issuer who claims for damages of the infringement from a CRA.⁴⁷

5. IOSCO Code of Conduct for CRAs

The International Organization of Securities Commissions (IOSCO) issued *Principles Regarding the Activities of Credit Rating Agency* in September 2003 and *Code of Conduct Fundamentals for Credit Rating Agencies* in March 2015. The IOSCO CRA Principles list four objectives for CRAs, regulators, rated entities and other market players: (i) quality and

⁴⁴ European Commission, "Public Consultation on Credit Rating Agencies" (11 May 2010), available at: http://ec.europa.eu/internal_market/consultations/docs/2010/cra/cpaper_en.pdf.

⁴⁵ Article 6a Item 1 of the *Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies*

⁴⁶ Title IIIA, Article 35a "Civil Liability", Item 1 of EC 1008/2009.

⁴⁷ *Ibid*, Item 2.

integrity of the credit rating process; (ii) independence and conflicts of interest; (iii) transparency and timeliness of ratings disclosure; (iv) confidential information.⁴⁸

6. Type 10 of Financial Services License in Hong Kong

Under the CAP 571 Securities and Futures Ordinance, the Securities and Futures Commission (SFC) started to implement licensing of credit rating agencies and their rating analysts on June 1, 2011. The SFC issued license of Type 10 (providing credit rating services) to Moody's, S&P, Fitch, A.M. Best Asia-Pacific and CTRISKS in 2011. In June 2012, China Chengxin (Asia Pacific) Credit Ratings Company Limited obtained the license of providing credit rating services (Type 10) granted by the Securities and Futures Commission (SFC) in Hong Kong and became the first overseas CRA of Mainland China.⁴⁹

C. Case Study on the CRAs' Liability in the United States

1. Arguments For and Against CRA Liability

Prior to the 2008 crisis, NRSROs were generally immune from civil liability or compensation either for misrepresentation as an expert under Section 11 of the 1933 Securities Act or for fraudulent liability under 10(b)-5 of the 1934 Exchange Act. In those few lawsuits against CRAs, such as *Washington Pub. Power Supply System* (1983),⁵⁰ *Executive Life Bankruptcy* (1991),⁵¹ *Jefferson Cty. Colo. Sch. Dist. v. Moody's* (1995),⁵² and *Newby v. Enron Corp.* (2005),⁵³ courts generally "have not held credit rating agencies accountable for alleged professional negligence or fraud and that plaintiffs have not prevailed in litigation against them."⁵⁴ However, the aftermath of the subprime crisis greatly challenged the role of CRAs and thus triggered the debate over CRAs' liability.

The disagreements over the proper role of CRAs in rating securities concern the CRAs' role

⁴⁸ See IOSCO Technical Committee, Statement of Principles Regarding the Activities of Credit Rating Agencies (September 2003), available at: www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf.

⁴⁹ Refer to the website of China Chengxin (HK), www.ccxap.com.

⁵⁰ 666 P.2d. 329 (1983).

⁵¹ 942 F.2d 1457 (9th Cir. 1991).

⁵² 988 F. Supp. 1341 (D.C. Colo. 1999).

⁵³ 302 F.3d 295 (5th Cir. 2002).

⁵⁴ See Frank Partnoy, "Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective" (Univ. San Diego Sch. of L., Legal Studies Paper No. 09-014, 2009), available at: <http://ssrn.com/abstract=1430608>.

as either “toolmaker” or “gatekeeper,” whether to apply fraud liability in “hostile ratings,”⁵⁵ and whether to establish corresponding conduct business rules as well. CRAs argue that they should be treated as “toolmakers”, as opposed to “gatekeepers” for whom liability should be imposed. In particular, CRAs stress credit ratings as a “predictive opinion” rather than an opinion of result.⁵⁶ However, there are reasons to not view CRAs as “toolmakers.” First, CRAs provide highly skilled services, which are required to satisfy minimum standards of care. Second, low-quality ratings may result in misallocation of capital, as evidenced during the subprime mortgage crisis.⁵⁷ The “gatekeeper” perspective subjects CRAs to liability for issuers’ wrongdoing. This argument contends that CRAs play a similar service role to other gatekeepers, such as securities analysts and auditors (both of whom may be held liable for wrongdoing in conjunction with the registration of securities).⁵⁸

Additionally, CRAs contend that ratings are predictive judgments, which are model-driven in the structured-finance context and the model methodology itself is subjective judgment.⁵⁹ Rule 436(g) exempted NRSROs from Section 11 liability for misstatements made in securities registration. In 2009, the SEC tried to rescind Rule 436(g), which provided an exemption to CRAs. However, CRAs lobbied against the rescission of the rule, indicating their hesitance to have their ratings included in an issuer’s registration statement.⁶⁰ In some recent lawsuits, such as *In re Moody’s Corporation*,⁶¹ CRAs have been sued for securities fraud. In that case, the plaintiffs brought a class action against the CRA for false and misleading statements, citing Sections 10(b) and 20(a) of the 1934 Exchange Act.⁶²

⁵⁵ In the context of CRA treatment, a “gatekeeper” refers to a CRA that is treated as an agent that serves as a check on the compliance of products within the securities market. “Toolmaker” status treats the CRA as an objective specialist in dealing with credit ratings. A “hostile rating” refers to a CRA rating that imposes negative effects on credit ratings.

⁵⁶ Caleb M. Deats, Note, “Talk that Isn’t Cheap: Does the First Amendment Protect Credit Rating Agencies’ Faulty Methodologies from Regulation?” 110 *COLUM. L. REV.* 1818 (2010).

⁵⁷ Bad, inadequate, or misleading credit ratings may attract capital to be invested in inefficient or poorly performing securities. The *In Re Fitch*, 330 F.3d 104 (2d Cir. 2003), *standard requires courts to be cautious in exempting CRAs from liability on First Amendment grounds.*

⁵⁸ Frank Partnoy, *How and Why Credit Rating Agencies are Not Like Other Gatekeepers* (Univ. San Diego Sch. of L., Legal Studies Paper No. 07-46, 2006), available at SSRN: <http://ssrn.com/abstract=900257>.

⁵⁹ John P. Hunt, *Credit Rating Agencies and the ‘Worldwide Credit Crisis’: The Limits of Reputation, The Insufficiency of Reform, and a Proposal for Improvement*, 2009 *COLUM BUS. L. REV.* 109 (2009).

⁶⁰ Robert Kohl, “Corporate & Financial Weekly Digest: Amendments to Dodd-Frank Act Introduced in House” (18 March 2011), KATTEN, MUCHIN, ROSENMAN, LLP, available at: <http://www.corporatefinancialweeklydigest.com/2011/03/articles/seccorporate-1/amendments-to-doddfrank-act-introduced-in-house/>.

⁶¹ 599 F. Supp. 2d 493 (S.D.N.Y. 2009).

⁶² *Ibid*

The final disagreement concerns imposing negligence liability. CRAs historically rely on First Amendment defenses to avoid the imposition of liability. The Credit Rating Reform Act of 2006 “prohibited states from regulating the ‘substance’ of credit ratings.”⁶³ Despite this prohibition, the issue of imposing liability remains. In addition to the debate over whether or not to impose liability, the question of what standard to apply is also widely debated. Specifically, the question of whether to apply strict product liability on credit ratings or the “reasonable standard” care for negligence liability remains unanswered and what remedy is appropriate (whether disgorgement of fees is sufficient or a broader, economic loss argument should be permitted, thereby allowing recovery for losses in the rated securities).⁶⁴

2. CRA Liability: An Overview of Relevant Case Law

The issue of imposing liability on CRAs for their ratings concerns a wide arena of the law: professional negligence, breach of contract, misstatement, violation of antitrust laws, and securities fraud. A review of some significant cases gives an overview of the main issues, barriers, and causes of action concerning CRA liability.

i. County of Orange v. McGraw Hill Cos.⁶⁵

In June 1996, Orange County brought a lawsuit for breach of contract and professional negligence against S&P. Orange County contended that S&P inflated its ratings of the County’s notes and bonds in 1993 and 1994. Orange County, which suffered a huge financial loss of \$5 billion from its risky investment in derivatives and high-yield bonds, filed for financial bankruptcy in December 1994. S&P, however, claimed that a CRA was protected by the First Amendment and exempted from professional negligence providing that S&P had no “actual malice” in overrating securities issued by the Orange County.⁶⁶ The “actual malice” standard, requiring “knowledge that the statement was false or with reckless disregard for whether or not it was true,” was applied in this case.⁶⁷ Ultimately, the lawsuit was dismissed, and Orange County accepted a nominal sum of \$140,000, which was equal to a partial refund of rating fees paid to S&P by Orange County in 1994.⁶⁸

⁶³ John P. Hunt, *Credit Rating Agencies and the ‘Worldwide Credit Crisis’: The Limits of Reputation, The Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM BUS. L. REV. 109 (2009).

⁶⁴ *Ibid*

⁶⁵ 245 B.R. 151 (C.D. Cal. 1999)

⁶⁶ *Ibid*

⁶⁷ *Hustler Magazine v. Falwell*, 485 U.S. 46, 56 (1988).

⁶⁸ *County of Orange*, 245 B.R. 151.

ii. Jefferson Cty. Sch. Dist. No. R-1 v. Moody's Investors, Inc.⁶⁹

In 1993, the Jefferson County School District decided to issue refunding bonds. Although it retained Moody's in the past, the School District chose two other CRAs to rate its bonds and did not provide any financial information to Moody's about this issuance. However, Moody's published its "Rating News" stating that the plaintiff's financial condition was not creditworthy and distributed this "rating" to Moody's subscribers. Moody's uninvited rating negatively affected the plaintiff's bond issuance. The plaintiff, Jefferson County School District, sued Moody's on three counts: (a) intentional interference with contractual and business relations; (b) materially false, misleading and derogatory statement; and (c) violations of the antitrust laws.⁷⁰ Like S&P in the Orange County case, Moody's argued for protection of expressions of opinion under the First Amendment;⁷¹ the court deemed this argument sufficient to grant a motion to dismiss.

iii. Abu Dhabi Comm. Bank v. Morgan Stanley & Co.⁷²

Abu Dhabi Commercial Bank together with other plaintiffs brought a lawsuit against defendants including S&P and Moody's for "common law fraud, negligent misrepresentation, negligence, breach of fiduciary duty, breach of contract, unjust enrichment, tortious interference with contract, and aiding and abetting."⁷³ The plaintiffs, contending that the CRAs produced false and misleading "top ratings" of Cheyne SIV Rated Notes issued to a select group of investors, sought compensation from the liquidation of notes. Morgan Stanley acted as the placement agent and engaged the CRAs to rate the debt offerings. In exchange for "top ratings" of the structured Cheyne SIV's portfolio, the CRAs received three times the normal fees for devising ratings. The Cheyne SIV went bankrupt in the crisis of subprime mortgages. The court denied the CRA's motion to dismiss the fraud claims. Unlike *County of Orange* and *Jefferson Cty. Sch. Dist.*, this case marks a significant turning point as the court rejected the CRA's free speech argument.⁷⁴

⁶⁹ 988 F. Supp. 1341 (D.C. Colo. 1999).

⁷⁰ *Ibid* at 1341

⁷¹ 245 B.R. 151 (C.D. Cal. 1999).

⁷² 651 F. Supp. 2d. 155 (S.D.N.Y. 2009).

⁷³ *Ibid* at 176

⁷⁴ See Matt Ribe, *Abu Dhabi Commercial Bank Co. v. Morgan Stanley & Co., Inc.*, BUS. L. BRIEF (Feb. 21, 2010) <http://businesslawbrief.com/abu-dhabi-commercial-bank-co-v-morgan-stanley-co-inc/>.

iv. Common Themes and Recent Cases

A common theme in these cases is the CRAs' use of the First Amendment as its primary defense against liability for CRAs' ratings. For instance, CRAs stress that their ratings are "pure opinion" or "public opinion;"⁷⁵ while plaintiffs argue CRAs should be subject to liability for issuers' misstatements or "hostile ratings."⁷⁶ Most recently, plaintiffs have brought "a broad array" of lawsuits against rating agencies in connection with structured investment vehicles based upon a few common law liability theories: breach of contract, negligence, fraud, and fiduciary duty.⁷⁷ One article provides a particularly apt summary of securities class action lawsuits as of November 15, 2008: there were approximately eighty 10b-5 related lawsuits and there were approximately twenty-four lawsuits concerning either Section 11 or 12(a)(2) liability.⁷⁸ Many of these lawsuits were filed in 2007 and 2008 after the "global credit crisis." In the trial of these lawsuits, courts have broken through previous barriers (such as the CRAs' use of the defenses of press privilege and pure opinion) in imposing liability for ratings.⁷⁹

Based upon recent cases (e.g. DoJ sued S&P in 2013 and is investigating Moody's for fraud, Bear Stearns sued Big Three, etc.) and practices concerning CRA liability in the United States, rating agencies should greatly raise their negligence standard of care, considering the factors of public interest, their role of "gatekeeper" and the increased global accountability on the part of rating agencies.

3. Related Ratings Reform in Legislation

An examination of the existing regulations concerning the liability of CRAs makes it apparent that deregulation is an unlikely policy choice. In examining current rules and

⁷⁵ See Lisbeth Freeman, "Who's Guarding the Gate—Credit-Rating Agency Liability as Control Person in the Subprime Credit Crisis", 33 VT. L. REV. 585 (2009).

⁷⁶ Examples include *Compuware Corp. v. Moody's Investors Servs. Inc.*, and *New Jersey Carpenters Vacation Fund v. Harvor View Mortgage Loan Trust*.

⁷⁷ William G. McGuinness, "Credit Ratings Agencies Under the Microscope: What to Expect in the Next Generation of Litigation", N.Y. L. J. (Jan. 5, 2009).

⁷⁸ See Allen Ferrell, Jennifer E. Bethel, & Gang Hu, "Legal and Economic Issues in Litigation Arising from the 2007-2008 Credit Crisis" (17 November 2008) *Harvard Law & Economics Discussion Paper No. 612*, available at: <http://ssrn.com/abstract=1096582>; PRUDENT LENDING RESTORED: SECURITIZATION AFTER THE MORTGAGE MELTDOWN 163-235 (Yasuyuki Fuchita, Richard Herring, & Robert Litan, eds., Brookings Institution Press 2009).

⁷⁹ See Freeman, "Who's Guarding the Gate—Credit-Rating Agency Liability as Control Person in the Subprime Credit Crisis", 33 VT. L. REV. 585 (2009).

regulations,⁸⁰ it is clear that CRAs were treated leniently before the subprime crisis. For example, CRAs are exempted from Regulation FD. Before 2009, Rule 436(g) exempted NRSROs from liability if they knowingly made false or misleading statements related to securities registration, although non-NRSRO CRAs were legally liable for their statements. *On July 22, 2010, the Dodd-Frank Act nullified SEC Rule 436(g) and thus imposed Securities Act Section 11 liability on rating agencies. Section 939A of the Dodd-Frank Act requires all federal agencies, within one year of passage, to end regulatory agency reliance on credit ratings and replace such references with alternative criteria that evaluate the credit-worthiness of an issuance. In the wake of the Dodd-Frank Act's changes, the SEC announced the end of the Regulation FD exemption for CRAs, which took effect on October 4, 2010.*⁸¹ However, as of March 16, 2011, members of the Capital Markets Subcommittee of the House Financial Services Committee introduced a few bills designed to repeal Section 939A of the Dodd-Frank Act.⁸² As a result, the debate over whether and how to impose liability on CRAs for their ratings is ongoing.

It is clear that “the [CRAs] have enjoyed significant barriers to liability in past financial and corporate scandals.”⁸³ If we refer to the congressional findings, a tentative conclusion is that rating agencies should greatly raise their negligence standard of care for rating agencies, considering the factors of public interest, their role of “gatekeeper” and the increased global accountability on the part of rating agencies.⁸⁴

⁸⁰ The rules and regulations concerning CRAs' liability in their ratings include: (i) Section 11 of the *1933 Securities Act* - Civil Liabilities on Account of False Registration Statement; (ii) Section 15 of the *1933 Securities Act* - “Liability of Controlling Persons”; (iii) Section 10(b) of the *1934 Exchange Act*; (iv) Section 18 of the *1934 Exchange Act* - “Exemption from State Regulation of Securities Offerings” provides civil remedies for misleading statement concerning documents filed with the SEC; (v) “Aiding and Abetting Liability” under the *Investment Advisers Act of 1940* (the “Advisers Act”); (vi) Consumer Credit Protection Act / Fair Credit Reporting Act of 1970 (FCRA); (vii) The *Private Securities Regulation Reform* (1995); (viii) Regulation FD; (ix) The Sarbanes-Oxley Act of 2002: SEC holds hearings on performance of rating agencies; (x) The *Credit Rating Reform Act of 2006*; (xi) The *Dodd-Frank Wall Street Reform and Consumer Protection Act (2010)*.

⁸¹ SEC Removal from Regulation FD of the Exemption for Credit Rating Agencies, 17 C.F.R. § 243 (2010).

⁸² Robert Kohl, “Corporate & Financial Weekly Digest: Amendments to Dodd-Frank Act Introduced in House” (18 March 2011), KATTEN, MUCHIN, ROSENMAN, LLP

⁸³ John C. Coffee Jr., “Rating Reform: The Good, The Bad, and The Ugly” (2010) *Columbia Law & Economics Working Paper No. 375*, available at; <http://ssrn.com/abstract=1650802>.

⁸⁴ Dustin Hall, “Dodd-Frank Wall Street Reform Bill Significantly Modifies the Regulation of Credit Rating Agencies” (2 July 2010), BANK BRYAN CAVE, LLP, available at: <http://www.bankbryancave.com/dodd-frank-wall-street-reform-bill-significantly-modifies-the-regulation-of-credit-rating-agencies/>.

D. Major CRAs in China

1. China Chengxin Credit Rating Group

Founded in October 1992 as the first national credit rating agency approved by the PBOC, China Chengxin Credit Rating Group (China Chengxin) has become a leading credit rating provider. In 2006, China Chengxin established a joint venture with Moody's. Moody's brings internationally advanced rating technologies and methodological systems into CCXI. As a leading rating service provider in enterprise bonds, short-term financial bonds, structured financial products and debt financing instruments, China Chengxin has rated over 9,000 corporations, banks and financial institutions in China.⁸⁵

CCXI has obtained various rating qualifications granted by the regulatory authorities:⁸⁶

(a) People's Bank of China

Letter on Approval of the Business Scope of China Chengxin International Credit Rating Co., Ltd. (YH [1997] No. 424)

Bond Credit Rating Qualification (YF [1997] No. 547)

Recognized interbank bond market credit rating agency

(b) China Insurance Regulatory Commission

One of the first recognized credit rating agencies that are put on records

(c) State Development and Reform Commission

Recognized corporate bond rating agency

(d) State Economic and Trade Commission

Approved to participate in the pilot work for credit rating of small and medium-sized enterprises

(e) Beijing Financial Assets Exchange

Identified as the first credit rating agency acquiring the membership in China

(f) Beijing Zhongguancun Management Committee

Identified as a member of Beijing Zhongguancun Enterprises Credit Promotion Association and approved to participate in the credit rating for enterprises in Zhongguancun

⁸⁵ Refer to the website of CCXAP, www.ccxap.com/About.aspx.

⁸⁶ This information is according to an interview with China Chengxin in November 2015.

Over the past two decades, China Chengxin has developed the following rating products and services and achieved many first places in China's credit rating industry.⁸⁷

	Products and Services	Remarks
Corporate Financing Rating	<p>Rating for corporate bond, SME collective bond and private placement bond;</p> <p>Rating for short-term financing bond, super short-term financing bond, medium term note, non-public orientated debt financing instrument as well as SME collective note;</p> <p>Rating for SME regional optimal notes, perpetual notes and convertible notes;</p> <p>Project income notes, project income bonds, etc.</p>	<ul style="list-style-type: none"> - Conducted first rating of central enterprise bonds in 1993; - First to rate convertible bonds for listed companies in 2001; - First to promote the rating system for Corporate Governance of Listed Companies in China in 2005; - First to rate convertible bonds with detachable warrants in 2006;
Financial Institution Rating	<p>Rating for comprehensive financial strength of financial institution (or subject rating): rating for comprehensive financial strength of bank, rating for comprehensive financial strength of insurance company, subject rating for security company, subject rating for bonding company, subject rating for financial leasing company, subject rating for automobile finance company, etc.;</p> <p>Financial institution debt rating: financial bond rating, secondary bond rating, Grade II capital bond rating, preferred stock rating, etc.</p>	<ul style="list-style-type: none"> - Conducted China's first financial institute bond rating in 1998; - First to rate fund management companies in 2002; - First to rate insurance companies' subordinated debts in 2004; - First to rate both comprehensive and individual financial strengths of 15 Chinese banks in 2004; - First to rate short-term financial bonds in 2005; - First to rate MTNs in 2008; - Firstly carried out securitization rating on commercial bank loans to SMEs in 2008; - First to rate financial leasing companies in 2010; - First to rate perpetual notes in 2012; - First to rate supply chain notes in 2013
Rating of Local Government	<p>Rating for the government and relevant issuers;</p> <p>Rating for general and special bonds</p>	<ul style="list-style-type: none"> - First to rate regional risk for 32 provinces and cities in China in 2004;

⁸⁷ Refer to the website of CCXAP, <http://www.ccxap.com/About.aspx>.

Bonds	<p>of local government; Rating for debt financing instruments of the financing platform; Project income bond rating; Research and analysis on credit power of local government.</p>	
Structured Finance Rating	<p>Corporate loan securitization (CLO); Auto loan asset-backed securitization (Auto loan-ABS); Residential mortgage backed securitization (RMBS); Commercial mortgage backed securitization (CMBS); SME loan asset-backed securitization (SME-ABS); Financial lease asset-backed securitization (Lease-ABS); Credit card asset-backed securitization (Credit Card ABS); Non-performing loan securitization (NPL Securitization); Asset-backed notes (ABN);</p>	<p>- First to rate CLO in 2005; - First to rate RMBS in 2005; -First to rate special asset management plans in 2005; -First to rate First to rate trust beneficiary rights for the NPL disposal in 2003; - First to rate CMBS in 2007; - First to rate real estate investment trusts (REITs) in 2009; - First to rate securitization rating on leasing assets in 2014</p>
Sovereign Rating Service	<p>Issue sovereign ratings for the world's major countries on a regular basis; Issue the <i>Trend Report for Global National Credit Risks</i> on a regular basis; Issue the <i>Research Report for National Debt Capacity and Sovereign Rating</i> on a regular basis, and analyze the Debt Capacity and credit status of the sovereign country; Research on the sovereign credit risks of the countries along the “One Belt and One Road”</p>	
Research and Consulting	<p>Establish a complete rating data base; Research and development of innovative business rating models; Analysis on macro economy and security market risks; Research on rating industry development and verification for rating performance of interest margin and transfer matrix; Provide the research and information consulting services related to the risk management analysis; Postdoctoral workstation</p>	<p>- Developed first credit rating system in China in 1992; - research projects cover sovereign risks; One Belt and One Road country risk; local government debts; research on innovation and risks of internet finance and business type; credit risk measurement and pricing research</p>

2. Dagong Global Credit Rating Co., Ltd.

Dagong Global Credit Rating Co., Ltd. (Dagong Global) Was founded in 1994 with the approval of the People's Bank of China and the previous State Economic and Trade Commission. As a nationally recognized credit rating company, Dagong Global has 600 staffs working in 34 domestic branches and two overseas branches.⁸⁸ In order to improve the internationalization of China's credit system and the construction of credit and information service market, Dagong Global signed a cooperative framework agreement with the Xinhua Net.⁸⁹

Dagong Global pursues to reveal the connection between credit rating and social and economic development, reform the international credit rating system and develop the responsibility of credit rating.⁹⁰ After the global financial crisis, Dagong Global built its sovereign rating standard as the first sovereign ratings in China.⁹¹ In the summer of 2010, Dagong Global issued China's first sovereign ratings report, which lowered the ratings of advanced countries (e.g. U.S., U.K. and France) and raised ratings of emerging markets.⁹²

In September 2010, Dagong Global applied to the Securities and Exchange Commission (SEC) for registration as a NRSRO. However, the SEC denied its application for the reason that Dagong Global was not possible to "comply with the recordkeeping, production, and examination requirements of the federal securities laws".⁹³

In order to realize its internationalization strategies, Dagong Europe Credit Rating Srl (Dagong Europe) was founded in Italy and registered as an European CRA in June 2013.⁹⁴ In July 2014, Dagong Global Credit Rating (Hong Kong) Co., Ltd. (Dagong HK) obtained the Type 10 license granted by the Securities and Futures Commission of Hong Kong (SFC). Dagong HK provides credit rating services for both entities and issuances, one-time and on-going, solicited and unsolicited, as well as both private and public ratings.⁹⁵

⁸⁸ Refer to the website of Dagong Global, <http://en.dagongcredit.com/index.html>.

⁸⁹ Xinhua Net, "Xinhua Net and Dagong Global Signed the Cooperative Framework Agreement" (21 May 2009), available at: http://news.xinhuanet.com/politics/2009-05/21/content_11414709.htm.

⁹⁰ See the website of Dagong Global, <http://en.dagongcredit.com/>.

⁹¹ Ibid

⁹² <http://finance.sina.com.cn/g/20100925/18198703593.shtml>

⁹³ SEC, "In the Matter of the Application of Dagong Global Credit Rating Co., Ltd." [Admin. Proc. File No. 3-13860] (22 September 2010), available at: <https://www.sec.gov/litigation/opinions/2010/34-62968.pdf>.

⁹⁴ See the ESMA list of registered and certified CRAs as of June 3, 2013.

⁹⁵ See the website of Dagong HK,

http://www.dagonghk.com/AboutUs.php?act=list&parent_id=19&menu_id=251.

3. China Lianhe Credit Rating Co., Ltd.

China Lianhe Credit Rating Co., Ltd. (China Lianhe) was founded on the basis of restructuring of Fujian Province Credit Rating Committee in January 2000 in Beijing. Its registered capital is RMB 136 million yuan. In August 2007, China Lianhe established a joint-venture CRA with Fitch. At present, United Credit Management Limited holds 51% shares of China Lianhe as the controlling shareholder; Fitch holds 49% shares of China Lianhe.⁹⁶ China Lianhe has obtained all credit rating qualifications in China's capital markets and credit markets granted by the NDRC, PBOC, CSRC, CIRC and Ministry of Industry and Information Technology (MIIT). In 2015, China Lianhe undertook 1,101 rating projects, including 1,032 initial rating projects; It participated ratings of 624 bonds, whose issue volume was RMB 1.12 trillion yuan.⁹⁷

4. Shanghai Brilliance Credit Rating & Investors Services Co., Ltd.

Shanghai Brilliance Credit Rating & Investors Services Co., Ltd. (Shanghai Brilliance Rating) was founded in July 1992. As the first Chinese CRA that obtained all qualification and licenses (including License of Enterprise Bond Rating and License of Inter-bank Market Ration granted by PBOC, License of Enterprise Bond Ration granted by NDRC, License of Eligible CRA granted by CIRC and License of Corporate Bond Rating granted by CSRC) from Chinese supervisory authorities, it has established a technical cooperation with Standard & Poor's Ratings Services (S&P). Its ratings cover commercial papers, medium-term notes, corporate bonds, enterprise bonds, small and medium enterprises (SMEs) collective notes, financial bonds, asset-backed securities, local government bonds.⁹⁸ In particular, Shanghai Brilliance Rating has obtained quite a few first places in China's credit rating industry. It issued the first investment value report for Tsingtao Brewery Company Limited in 1994, the first bond rating of a securities company for Guotai Junan Commercial Paper in 2005, the first three ratings of collective notes of SMEs in 2009, the first foreign RMB-denominated bond rating for the Bank of Tokyo-Mitsubishi UFJ (China), Ltd. in 2010, and the first local government bond rating for Guangdong Province in 2014.⁹⁹

⁹⁶ Refer to the website of China Lianhe, www.lhratings.com.

⁹⁷ Ibid

⁹⁸ Refer to the website of Shanghai Brilliance Rating, www.shxsj.com.

⁹⁹ Ibid

E. The Multiple Regulatory System of China's Credit Rating Industry

In corresponding to the regulatory system of China's bond market, China's credit rating industry is regulated by a multiple supervisory system. There are a few regulators. The People's Bank of China is the regulator of interbank bond market bond rating, which concerns issuance of treasury bonds, government bonds, municipal bonds, central bank bills, short-term financial bonds, non-banking financial bonds and asset backed securities (ABS). China Securities Regulatory Commission is the regulator of exchange market bond rating, which concerns corporate bonds, government bonds and convertible bonds. In addition, credit ratings relating to issuance of enterprise bonds and certain bonds invested by insurance capitals must be accredited by the National Development and Reform Commission (NDRC) and China Insurance Regulatory Commission (CIRC) respectively.

To engage in the securities rating business, a CRA applying for the license from the CSRC must have the Chinese legal person qualification.¹⁰⁰ Securities rating services include four categories of objects: (i) The bonds, asset-backed securities and other fixed income or debt structured finance securities as issued upon approval of the CSRC; (ii) The bonds, asset-backed securities and other fixed income or debt structured finance securities listed for trading at a stock exchange, except for national debts; (iii) The securities issuers, listed companies, non-listed public companies, securities companies and securities investment fund management companies prescribed in Item (i) and (ii); and (iv) Other objects as prescribed by the CSRC.¹⁰¹

1. Multiple Regulators

Prior to the establishment of the exchange bond market, the PBoC was the single regulator of the ratings market. The segmented bond market and the split supervisory system of financial market lead to a multiple regulator system for the ratings market. The rating activities must follow relevant rules enacted by the following regulators:

- (a) PBoC and National Association of Financial Market Institutional Investors (NAFMII)
- (b) NDRC

¹⁰⁰ Article 7 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.

¹⁰¹ *Ibid*, Article 2.

- (c) CSRC and China Securities Industry Association
- (d) CIRC
- (e) CBRC
- (f) MOF, SAFE and MOC
- (g) Local Government Authorities

	The Inter-bank Bond Market (The PBoC as the Major Regulator)	The Exchange Bond Market (The CSRC as the Major Regulator)
PBoC	Commercial papers (CP), ultra-short-term financial bonds with a term of 270 days issued by non-financial enterprises, medium-term notes (MTN), small and medium sized enterprises collection notes (SMECN), and private placement notes (PPN) ¹⁰² and project revenue note (PRN) in the inter-bank bond market	
CSRC		The CSRC and its dispatched offices shall supervise and administrate the securities rating business activities, ¹⁰³ including: Short-term bonds issued by securities companies, corporate bonds, non-publicly issued corporate bonds (including privately raised SME bonds) and securitization products in the exchange market.
CBRC	Financial bonds issued by commercial banks, financial companies, financial lease companies, Tier 2 capital bonds of commercial banks, securitization products in the inter-bank bond market	
CIRC	Subordinated debts of insurance companies	
MOF	Local Government Debts	Local Government Debts

¹⁰² “Private placement notes”, also called as “private placement bonds of small and medium enterprises”, refer to the corporate bonds non-publicly issued and transferred by micro, small and medium enterprises within the territory of China, with principal and interest repaid within an agreed time limit”. See Article 2 of the *Shanghai Stock Exchange on Issues Concerning the Issuance and Implementation of the Pilot Measures of the Shanghai Stock Exchange for the Issuance of Private Placement Bonds of Small and Medium Enterprises* enacted on May 22, 2012.

¹⁰³ Article 6 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.

Ministry of Commerce (MOC)	Short-term bonds and medium-term notes issued by non-financial lease companies	
NDRC	Enterprise bonds, project revenue bonds, small and medium enterprises collection notes, and micro and small enterprises support bonds in the inter-bank bond market	Enterprise bonds, project revenue bonds, small and medium enterprises collection notes, and micro and small enterprises support bonds in the exchange market

2. Cross supervision

In corresponding to the multi-supervisory system of bond market, the credit rating business is subject to the supervision of multiple supervisory authorities, including the PBC, CSRC, CBRC, CIRC, NDRC, MOF, MOC, as well as two self-regulatory organizations – NAFMII and SAC. Of these organizations, the PBOC and NAFMII are the main supervisors of ratings in the inter-bank bond market; the CSRC and SAC are the main supervisors of ratings in the exchange market.

Under the multiple supervisory system of credit rating industry, some credit rating activities are subject to cross supervision: (i) Ratings of debt financing instruments issued by non-financial institutions such as commercial papers (CP), ultra-short-term financial bonds with a term of 270 days issued by non-financial enterprises, medium-term notes (MTN), small and medium sized enterprises collection notes (SMECN), and private placement notes (PPN) and project revenue notes (PRN) in the inter-bank bond market are subject to the supervision of the PBOC and NAFMII; (ii) Ratings of enterprise bonds, project revenue notes, small and medium sized enterprises collection notes, which are approved by the NDRC and traded in both the inter-bank bond market and the exchange market, are subject to the supervision of the NDRC, PBOC, CSRC, NAFMII and SAC; (iii) Ratings concerning financial bonds issued by commercial banks in the inter-bank bond market are subject to supervision by the PBOC, CBRC and NAFMII; (iv) Ratings of bonds issued by insurance company in the inter-bank bond market are subject to the supervision of the PBOC, CIRC and NAFMII; (v) Ratings of financial bonds issued by financial companies and financial lease companies are subject to the supervision of CBRC, PBOC and NAFMII; (vi) Ratings of short-term bonds and medium-term notes issued by non-financial lease companies are subject to supervision of the PBC, MOC and NAFMII; (vii) Ratings of securitization products issued in the inter-bank

bond market are subject to the supervision of the PBOC, CBRC and NAFMII; (viii) Ratings of securitization products in the exchange market are subject to the supervision of the CSRC and stock exchange(s); (ix) Ratings concerning local government debts in the inter-bank bond market are subject to the supervision of the MOF, PBOC and NAFMII; (x) Ratings concerning local government debts in the exchange market are subject to the supervision of the MOF, CSRC and stock exchange(s); (xi) Ratings of corporate bonds and private placement bonds are subject to supervision of the CSRC and stock exchange(s).

The multi-regulatory system derives from the split regulatory system of the bond market. Since different regulators may pursue different supervisory criteria and enforcement policies, in practice, it may result in regulatory loopholes and regulatory arbitrage.

3. Two Self-regulatory Organizations (SROs): NAFMII and SAC

The National Association of Financial Market Institutional Investors (NAFMII) was founded in September 2007 in Beijing with the approval of the State Council. As of April 2012, members of the NAFMII were composed of 141 banks, 131 non-bank financial institutions, 5 financial service intermediaries, 475 intermediaries including credit rating agencies, 1911 corporations, Ministry of Railways and National Council for Social Security Fund.¹⁰⁴ The NAFMII enacted the *Self-regulatory Guideline for Credit Rating Business of Non-financial Enterprise Debt Instruments*, which was implemented on January 8, 2013. This self-regulatory guideline encourages double ratings.¹⁰⁵ The NAFMII recognizes six CRAs' ratings in the inter-bank bond market:¹⁰⁶

- (1) China Chengxin Credit Rating Group
- (2) China Lianhe Credit Rating Co., Ltd.
- (3) Dagong Global Credit Rating Co., Ltd.
- (4) Shanghai Brilliance Credit Rating & Investors Services Co., Ltd.
- (5) China Bond Rating Co., Ltd.
- (6) Golden Credit Rating International Co., Ltd.

The Securities Association of China (SAC) was founded in August 1991 in Beijing. Members of the SAC are composed of 109 securities companies, 84 securities investment consulting

¹⁰⁴ Refer to the website of NAFMII, www.nafmii.org.cn.

¹⁰⁵ Article 6 of the NAFMII's *Self-regulatory Guideline*.

¹⁰⁶ Refer to the website of NAFMII, www.nafmii.org.cn.

institutions, 6 CRAs, the China Great Wall Asset Management Corporation (CGWAMC), and other ordinary and special members.¹⁰⁷ The SAC recognizes six ratings of CRAs in the exchange market:

- (1) China Chengxin Securities Rating Co., Ltd.
- (2) China Lianhe Credit Rating Co., Ltd.
- (3) Dagong Global Credit Rating Co., Ltd.
- (4) Shanghai Brilliance Credit Rating & Investors Service Co., Ltd.
- (5) Golden Credit Rating International Co., Ltd.
- (6) Pengyuan Credit Rating Co., Ltd.

In accordance with the *Administrative Measures for Debt Financing Instruments of Non-Financial Enterprises in the Inter-bank Bond Market*, the National Association of Financial Market Institutional Investors (NAFMII) issued the *Self Regulatory Guidance on the Credit Rating Business of Debt Financing Instruments of Non-financial Enterprises* on January 8, 2013.

Under the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market*, the Securities Association of China (SAC) carries out the self-disciplinary management of securities-related ratings.¹⁰⁸ In September 2009, five accredited CRAs (China Chengxin, Dagong Global, China Lianhe, Shanghai Brilliance and Pengyuan Rating) signed the *Self-Disciplinary Convention of Credit Rating Industry*.¹⁰⁹ In January 2015, the SAC issued the *Detailed Rules for Implementation on Rating Business of Credit Rating Agencies in the Securities Market (Trial)*. This implementation rules stipulate criteria of business conduct for CRAs' due diligence, rating report, information disclosure and internal control.

¹⁰⁷ Refer to the website of SAC, www.sac.net.cn.

¹⁰⁸ Article 6 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.

¹⁰⁹ Jiening Hou, "Five CRAs Signed Industry's Self-Disciplinary Convention" (29 September 2009) *Securities Daily*, available at: <http://finance.sina.com.cn/stock/t/20090929/02216803624.shtml>.

F. Other Legal Issues Concerning Chinese CRAs

1. Market Access

In the latest *Catalogue for the Guidance of Foreign Investment Industries* (2015 Amendment), credit investigation and rating services are still listed as one of “restricted foreign investment industries”.¹¹⁰ In order to engage in credit rating services in Chinese bond markets, an accredited CRA shall be a Chinese legal person.¹¹¹ A foreign CRA may establish a joint venture with a Chinese CRA in order to get access to Chinese ratings market, upon the approval of the Ministry of Commercial. The shareholding ratio of a foreign CRA in the joint venture is capped at 49%. In September 1998, China Chengxin and Fitch Ratings established China’s first joint-venture CRA -- China Chengxin International Credit Rating Co. In 1999, Dagong Global and Moody’s announced their technological cooperation. In 2006, Moody’s acquired 49% shares of China Chengxin International Credit Rating Co., Ltd. In May 2008, Fitch Ratings acquired 49% shares of China Lianhe. In August 2008, Standard & Pool’s signed strategic cooperative agreement with Shanghai Brilliance Credit Rating & Investors Services Co., Ltd.¹¹²

After 2000, the NDRC granted the following CRAs of qualification for enterprise bond ratings:¹¹³

- (1) Dagong Global Credit Rating Co., Ltd.
- (2) China Chengxin Credit Rating Group
- (3) China Lianhe Credit Rating Co., Ltd.
- (4) Shanghai Brilliance Credit Rating & Investors Services Co., Ltd.
- (5) Shanghai Far East Credit Rating Corporation

In March 2006, the PBoC issued the *Guiding Opinions on the Credit Ratings Management of*

¹¹⁰ See Item 29 of “Restricted Foreign Investment Industries” promulgated by the NDRC and Ministry of Commerce on March 10, 2015. Credit rating services have been categorized as “restricted foreign investment industry” since 2007.

¹¹¹ Article 7 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007. See also Article 3 of the *Guiding Opinions of the People’s Bank of China for the Management of Credit Rating* issued by the PBoC on March 29, 2006 and amended in 2015.

¹¹² Dagong Global, “A Brief History of China’s Credit Rating Industry”, available at: <http://www.dagongxypj.com/credit.php?pid=4961&tid=118>.

¹¹³ On September 11, 2003, the NDRC issued the Notification of NDRC Finance No. [2003] 1179 and confirmed five accredited CRAs that had undertaken credit ratings for big SOEs specifically approved by the State Council.

the People's Bank of China, which required qualified CRAs should register with the PBoC when undertaking the practice of ratings of financial products, lending enterprises and guarantee agencies in the inter-bank bond market and credit market.¹¹⁴ Six CRAs have been recognized by the PBOC to provide rating services for interbank bond market.¹¹⁵

- (1) China Chengxin Credit Rating Group
- (2) China Lianhe Credit Rating Co., Ltd.
- (3) Dagong Global Credit Rating Co., Ltd.
- (4) Shanghai Brilliance Credit Rating & Investors Services Co., Ltd.
- (5) China Bond Rating Co., Ltd.
- (6) Golden Credit Rating International Co., Ltd.

In August 2007, the CSRC issued the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market*, which required a CRA to engage in credit ratings business regarding the securities market should apply to the CSRC for the securities rating business licensing.¹¹⁶ Five CRAs have been approved by the CSRC as accredited CRAs:

- (1) China Chengxin Credit Rating Group
- (2) China Lianhe Credit Rating Co., Ltd.
- (3) Dagong Global Credit Rating Co., Ltd.
- (4) Shanghai Brilliance Credit Rating & Investors Services Co., Ltd.
- (5) Pengyuan Credit Rating Co., Ltd.

In 2003, the China Insurance Regulatory Commission (CIRC) allowed insurance companies to invest in enterprise bonds rated as AA or above by CRAs accredited by the regulatory authority. Thereafter, the following CRAs were recognized to provide rating services for insurance funds' investments in bonds.¹¹⁷

- (1) China Chengxin Credit Rating Group
- (2) China Chengxin International Credit Rating Co.

¹¹⁴ Article 1 of the *Guiding Opinions* issued by the PBoC on March 29, 2006.

¹¹⁵ PBoC, "The List of Qualified Rating Agencies Whose Rating Results Can Be Used in the Inter-bank Bond Market (PBoC)", available at: <http://www.lhratings.com//static/pdf/rmyhw.pdf>.

¹¹⁶ Article 2 of the *Interim Measures* issued by the CSRC on August 24, 2007.

¹¹⁷ See the *Interim Measures for the Administration of Insurance Companies' Investing in Enterprise Bonds* issued by the CIRC on May 30, 2003 and nullified on December 2, 2010. See also the *Announcement of the China Insurance Regulatory Commission on the Recordation of Recognized Capability of the Credit Rating Institution* issued on October 9, 2013.

- (3) China Lianhe Credit Rating Co., Ltd.
- (4) United Credit Ratings Co., Ltd.
- (5) Dagong Global Credit Rating Co., Ltd.
- (6) Shanghai Brilliance Credit Rating & Investors Services Co., Ltd.
- (7) Shanghai Far East Credit Rating Corporation
- (8) China Bond Rating Co., Ltd.

The access to credit rating services in bond markets has been strictly managed by relevant regulators since mid-2000s. Of the Chinese CRAs that engage in nationwide credit rating business, four major CRAs (China Chengxin, Dagong Global, China Lianhe and Shanghai Brilliance) have full licensing accredited by four government authorities (PBoC, CSRC, NDRC and CIRC) to provide rating services in both inter-bank bond market and exchange bond market.

2. Avoidance from Conflicts of Interest and “Reputation Hypothesis”

Since China’s credit rating industry has a short history, the reputational mechanism does not work well and the competition for high rating grades has been serious.¹¹⁸ In March 2006, Fuxi Investment Holding Limited issued the first phase of its short-term bonds -- “06 Fuxi CP01” whose issuing scale was CNY 1 billion and was due in March 2007. This is the first short-term financial bill issued by a non-listed privately operated (*Minying*) enterprise. “06 Fuxi CP01” was rated as “A-1” by Shanghai Far East Credit Rating Co., Ltd. (Shanghai Far East Rating) on December 28, 2005. However, Fuxi Investment involved in the scandal of Shanghai social security fund and some assets were frozen by the court in July. On July 26, 2006, Shanghai Far East Rating initiated the tracking rating system and announced the rating of “A-1” became temporarily invalid.¹¹⁹ Thereafter, plenty of Fuxi’s bonds were undersold.¹²⁰ On August 21, 2006, Shanghai Far East Rating downgraded the rating of “06 Fuxi CP01” to grade “C” for the reason of undisclosed loan guarantees for one of its

¹¹⁸ Yuanfan Zhou, “Establishing a Proper System to Avoid from Credit Ratings Competition” *China Securities*, 2012, Vol. 9, pp. 71-75.

¹¹⁹ Shousong Xu and Lu Gao, “Fuxi Investment Holding Ltd. Created assets of CNY 10 Billion in Four Years: Uncover the Myth of Its Capital Operation” (17 August 2006) *People’s Daily*, available at: <http://finance.people.com.cn/GB/1040/4713491.html>.

¹²⁰ According to the CSRC’s requirement at that time, monetary market funds should invest in grade “A-1” or above short-term bonds; when there is a downgrade and the rating of short-term bonds is lower than “A-1”, the short-term bonds must be sold in 20 trading days after the downgrade report is released. See Article 3 of the *Circular of China Securities Regulatory Commission on the Investment of Monetary Market Funds in Short-term Financing Bonds* issued by the CSRC on September 22, 2005 and became invalid.

shareholders, and thus became the first junk bond in Mainland China. The “Fuxi Event” called into question on the authority of domestic rating agencies. This event also negatively affected the reputation of Shanghai Far East Rating and its rating business declined thereafter.¹²¹

Take the example of the “AAA” grade of the Ministry of Railways. On August 8, 2011, the Ministry of Railways issued ninety-day super-short term financial bonds which valued at CNY 20 billion and the interest rate of bid winner was 5.55%. These bonds were rated as grade “AAA” by Dagong Global. This news gave a surprise to the public media since the Ministry of Railways had quite a lot negative news (e.g. the bullet train accident in Wenzhou on July 23, 2011) at that time. It turns out that the interest margin for each grade of “AAA”, “AA” and “A” is about 30 basis points. In other words, the issuer may save CNY 150 million for raising one rating grade on the basis of issuing scale of CNY 20 billion.¹²² The short-term bills issued by the Ministry of Railways are regarded as “equivalent to national debts” because the Ministry of Railways bonds get implicit financial guarantee from the central government.¹²³

However, the grade “AAA” was questioned by the public because it was even higher than the grade “AA” of China’s national debts. In the first half of 2011, the debt ratio of the Ministry of Railways reached 58.33% (CNY 2.09 trillion in total with an annual interest of more than CNY 6 billion) but the accumulated net profit was only CNY 1.7 billion, according to its financial report.¹²⁴ Regarding the challenge of grade “AAA” of short-term railways bonds, the Dagong Global explained that the Ministry of Railways was both a state department and an enterprise legal person. If the Ministry of Railways was not able to pay the short-term bills, the state would pay back.¹²⁵ Further investigation shows that Dagong Global was the exclusive credit rating agency for the Ministry of Railways. The credibility of Dogong

¹²¹ Jieying Gao, “From ‘AAA’ to ‘D’: A Snapshot of China’s Credit Ratings” (2006), available at: http://www.jrbl.net/template3/magazine_c.aspx?y_id=100&b_id=294&id=367.

¹²² CNFOL, “Dagong Global Credit Rating Co., Ltd. Is Claimed to Have Frequent Business Connections with the Ministry of Railways and Monopolize Its Ratings” (11 August 2011) *National Business Daily*, available at: <http://news.cnfol.com/110811/101,1277,10456312,00.shtml>.

¹²³ Ibid

¹²⁴ Xingting Peng, “Where Does the Ministry of Railways’ Grade “AAA” Come from?” (9 August 2011) *Securities Times*, available at: <http://review.cnfol.com/110809/436,1705,10434624,00.shtml>.

¹²⁵ Jiawei Qiao and Yin Gao, “The Ministry of Railways Is Rated as “AAA” by Dagong Global: This Rating Is Higher than China’s National Credit” (10 August 2011) *National Business Daily*, available at: <http://news.cnfol.com/110810/101,1277,10448355,00.shtml>.

Global's "AAA" rating for railways bills indicates conflicts of interest between a CRA and its rated entity.¹²⁶

3. Independence of CRAs

In order to enlarge their market share, Chinese CRAs have attracted local government or financial institutions in their shareholding structure. Accompanying Chinese CRAs' establishing joint ventures with the "Big Three" (Moody's, S&P's and Fitch) in mid-2000s, state capitals started to acquire shares of privately operated CRAs too. The first acquisition with state capital background was conducted by the Dongfang Asset Management Company Ltd. ("Dongfang AMC"). In August, 2007, Dongfang AMC signed the share transfer agreement with the Golden International Credit Rating Co., Ltd. and held 60% shares of the latter. The acquired CRA was renamed as "Dongfang Golden Credit Rating Co., Ltd."¹²⁷ In December 2008, Dongfang AMC purchased 51% shares of Shanghai Far East Credit Rating Co., Ltd. and the latter became a subsidiary of Dongfang AMC group.¹²⁸

In 2009, state capitals engaged in the third acquisition of a privately operated CRA. Tianjin TEDA International Holding (Group) Co., Ltd. (TEDA Holding), which was founded by the Administration Committee of Tianjin Economic-Technological Development Area ("TEDA") as a local government platform to manage state-owned assets, purchased 50% shares of Lianhe Credit Rating Co., Ltd. (Lianhe Rating). Although Lianhe Rating did not need raise its capital and the joining of state capital did not add its credibility, Lianhe Rating was welcome to this acquisition because TEDA Holding controlled approximately 80% financial assets in Tianjin.¹²⁹

After December 2008, Dongfang AMC had two CRAs in its affiliated group - Shanghai Far East Credit Rating Co., Ltd. and Dongfang Golden Credit Rating Co., Ltd. (Dongfang Golden). After a restructuring of shareholding structure, Dongfang AMC held 83% shares of Far East Rating. The two CRAs competed each other a couple of years, and finally Dongfang

¹²⁶ CNFOL, "Dagong Global Credit Rating Co., Ltd. Is Claimed to Have Frequent Business Connections with the Ministry of Railways and Monopolize Its Ratings" (11 August 2011) *National Business Daily*, available at: <http://news.cnfol.com/110811/101,1277,10456312,00.shtml>.

¹²⁷ Bo Gao, "Ebb Tide of Foreign Capital: Great Capital Movements Reappear in Domestic Credit Rating Industry" 27 May 2009) *21st Century Economic Report*, available at: <http://finance.sina.com.cn/roll/20090527/06076277116.shtml>.

¹²⁸ Ibid

¹²⁹ Ibid

Golden obtained all rating licenses in both inter-bank bond market and securities bond market. Dongfang AMC decided to sell the Far East Rating. In November 2012, China Development Bank (CDB), China's biggest government-backed policy bank, took over the Far East Rating at the price of CNY 60.5 million.¹³⁰

In another example, Pengyuan Credit Rating Co., Ltd. (Pengyuan Rating) is a Shenzhen-based CRA with the background of state capitals. Pengyuan Rating has two shareholders: the Shenzhen Financial Electric Settlement Centre and the Shenzhen Chengben Credit Service Co., Ltd. The first shareholder is a subordinate of the PBoC.¹³¹ Since CRAs are supposed to play a third-party intermediary in the financial market, being controlled by state capitals or financial institutions may affect their status as an independent financial intermediary.

In accordance with the requirements of the CSRC, CRAs are forbidden from carrying out securities rating business for a rated entity in the following circumstances of actual or potential conflicts of interest: (i) A CRA and the rated entity are controlled by the same actual controller; (ii) A shareholder owns 5% or above shares of the rating agency, rated entity or rated securities issuer; (iii) A rated entity or the rated securities issuer and its actual controller directly or indirectly holds 5% or above shares of the rating agency; (iv) A CRA and its actual controller directly or indirectly holds 5% or above shares of rated securities issuer or rated entity; (v) A CRA and its actual controller buy or sell rated securities six months prior to the rated securities; (vi) A CRA receives payments unrelated to its rating service from the rated entity or rated securities issuer; (vii) A CRA and its actual controller, directors, supervisors, senior managers, CRA rating analysts and their intermediate relatives directly or indirectly hold 5% or above rated securities and derivatives of the rated entity or rated securities issuer; (viii) A CRA and its actual controller, directors, supervisors, senior managers, CRA rating analysts and their intermediate relatives directly or indirectly hold 5% or above rated securities and derivatives of the rated entity or rated securities issuer; (ix) Staff of the rated project and their intermediate relatives act as the case manager or the authorized signatory of securities service agencies such as accounting firm, law firm and financial consultant hired by the rated entity or rated securities issuer; (x) Other circumstances

¹³⁰ Caijing Net, "China Development Bank Takes over Far East Credit Rating Co., Ltd. and Dongfang AMC Gets out" (31 January 2013), available at: <http://finance.caijing.com.cn/2013-01-31/112476767.html>.

¹³¹ "The Second Round of Joint Ventures in Credit Rating Industry" (8 April 2015), available at: <http://m.xuehuile.com/blog/e7e7db49beb84af6a0ecf1f5b1c02350.html>.

stipulated by the CSRC or SAC that affect principles of independence, objectiveness and impartiality.¹³²

When a CRA's controlling shareholder or actual controller is a financial institute, the CRA may not be able to play an independent role when involving in the above-mentioned conflicts of interest. In addition, state capitals should avoid interfering with the competition of credit rating industry.

4. "Rating Shopping" and Accountability of Credit Ratings

By 2011, there were more than 200 CRAs in China and the competition for limited market resources was critical. The issuer pays model played a dominant role in the ratings market. It turned out that rating charges were positively correlated to rating grades and the rating shopping was serious. Rating fees rise on a scale of high to low. In other words, the issuer paid more for higher ratings.¹³³ The bond issuer chose a CRA through bidding; whoever provides higher rating and lower fees win the bidding.¹³⁴

However, different rating agencies may issue different ratings and ranks on the same peer-to-peer lending platform. For example, *Xin He Hui* was rated as "C-" and ranked as "97th" by a CRA - Rong 360, but was ranked as "19th" by another CRA – *Wang Dai Zhi Jia*.¹³⁵ The investigation shows that there are no universal criteria for P2P ratings and the authenticity of data about peer-to-peer platforms are questionable; meanwhile, some CRAs have to "adjust" the result of ratings to cater for rated entities' needs.¹³⁶ This raises the issues of "rating shopping" and accuracy of ratings.

In addition, the accountability of ratings has been questioned. It is common that the same rated entity got different ratings between domestic market and international market, or between inter-bank bond market and exchange bond market. Also, CRAs' external ratings are

¹³² See Article 12 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.

¹³³ China Economic Net, "Charge by Rating Grades" (15 August 2011), available at: http://finance.ce.cn/sub/2011/pjnj/xz/201108/15/t20110815_16620121.shtml.

¹³⁴ "The Rating System Leads to Competition for Rating Grades" (16 August 2011) *China Times*, available at: http://finance.ce.cn/sub/2011/pjnj/sp/lz/201108/16/t20110816_16620818.shtml.

¹³⁵ Xiaoli Lin, "Ratings on Peer-to-peer Platforms are in a Shambles: The Rank Difference of the Same Platform Rated by Different CRAs Can be 78" (14 January 2016) *Guangzhou Daily*, available at:

<http://www.chinanews.com/m/cj/2016/01-14/7715628.shtml>.

¹³⁶ Ibid

usually higher than the internal ratings of big banks. For example, some CRAs issue high grades of ratings. It is reported that Dagong Global issued 156 “AAA” grades for central enterprise bonds and corporate bonds of local governments’ investment platforms in 2010, including 15 credit ratings for enterprise, 3 enterprise bond ratings, 113 tracking ratings, 4 corporate bond ratings, 2 credit ratings for financial bond and 19 medium-sized notes. The 155 “AAA” grades accounted for 25% out of 624 ratings released on Dagong’s website.¹³⁷

In order to reform the issuer pays model, China Bond Rating Co., Ltd. was founded by the NADMII on behalf of all its members in August 2010. Its registered capital is RMB 50 million. China Bond Rating Co., Ltd. is the first CRA that adopts “investor pays model” in China.¹³⁸ China Bond Rating Co., Ltd. is a re-rating agency. Its business goal is to accumulate rating data of various industries and the NAFMII will quit after five to ten years.¹³⁹

5. The First P2P Rating Case: *Duanrong Net v. Rong 360*

Duanrong Net v. Rong 360 is the first lawsuit concerning peer-to-peer lending ratings. The plaintiff *Duanrong Net* sued the defendant *Rong 360* after its lending platform was rated as “C” and “C-” by *Rong 360*. The plaintiff claimed for a compensation of CNY 10 million. The cause of action is defamation infringement. The plaintiff challenged the legitimacy of *Rong 360*’s ratings because no CRAs got accredited from government authorities.¹⁴⁰ The first court hearing was on December 15, 2015 at the Beijing Municipal Haidian District People’s Court. The plaintiff did not recognize the unsolicited ratings made by the defendant. The People’s University of China was added as a third party of the litigation since it was a cooperative partner of *Rong 360*’s rating business.¹⁴¹ This case is still pending.

¹³⁷ Jian Hu, Yumin Li and Shuyang Chen, “Dagong Global Issued 156 ‘AAA’ Grades and Is Questioned for Abusing Ratings” (18 August 2011) *National Business Daily*, available at: http://finance.ce.cn/rolling/201108/18/t20110818_16622526.shtml.

¹³⁸ Refer to the website of China Bond Rating Co., Ltd., www.chinaratings.com.cn.

¹³⁹ Baidu Baike, “China Bond Credit Rating Co.”, available at: <http://baike.baidu.com/view/4413444.htm>.

¹⁴⁰ Sina Finance, “The Lawsuit of *Duanrong Net v. Rong 360* Upgrades: The People’s University of China Has Been Added as the Third-party Defendant” (29 February 2016), available at: <http://finance.sina.com.cn/money/bank/p2p/2016-02-29/doc-ifxpvysx1761748.shtml>.

¹⁴¹ Baidu Baijia, “*Duanrong Net* Brings a Lawsuit against *Rong 360* and Claims for a Compensation of CNY 10 Million – It’s the First Time that a P2P enterprise Says No to Ratings” (10 September 2015), available at: <http://wangqi.baijia.baidu.com/article/162028>.

Conclusion

The lessons from the role of CRAs in the subprime mortgage crisis raise critical issues such as conflicts of interest, accountability of ratings and liability of CRAs. As an emerging industry, China's credit rating services have made significant progress in credit rating procedure, methodology and reporting, accompanying the rapid development of China's bond market in the last decade. However, not only the rating results have been tested by default rate due to the short history of this industry, but also its self-regulatory system especially the reputational mechanism is weak. Furthermore, China's emerging credit rating sector operates under a multi-regulator system – the PBoC as the regulator of bond ratings on the nation's interbank bond market and the CSRC as the regulator of bond ratings on exchange market. This multi-regulatory system may result in inconsistent policies and regulatory arbitrage. In the near future, it will be adjusted in the financial system reform.

List of Abbreviations

ABN	Asset-backed notes
ABS	Asset-backed securitization
ACRAA	Association of Credit Rating Agencies in Asia
CBRC	China Banking Regulatory Commission
CIRC	China Insurance Regulatory Commission
CLO	Corporate loan securitization
CMBS	Commercial mortgage backed securitization
CRA	Credit Rating Agency
CSRC	China Securities Regulatory Commission
CP	Commercial papers
DOJ	Department of Justice
ESMA	European Securities and Markets Authority
FINMA	Swiss Financial Market Supervisory Authority
Fitch	Fitch Ratings Inc.
IOSCO	International Organization of Securities Commissions
MIIT	Ministry of Industry and Information Technology
MOC	Ministry of Commerce
MOF	Ministry of Finance
Moody's	Moody's Investors Service, Inc.
MSEs	Micro and small enterprises
MTNs	Medium-Term Notes
NAFMII	National Association of Financial Market Institutional Investors
NDRC	National Development and Reform Commission
NPL	Non-performing loan
NRSRO	Nationally <i>Recognized</i> Statistical Rating Organizations
OTC	Over-the-counter
PBoC	People's Bank of China
PPN	Private Placement Notes
PRN	Project revenue note
QFII	Qualified Foreign Institutional Investors

REIT	Real estate investment trusts
RMBS	Residential mortgage backed securitization
SAC	Securities Association of China
SAFE	State Administration of Foreign Exchange
S&P	Standard & Poor's Financial Services LLC
SEC	Securities and Exchange Commission
SFC	Securities and Futures Commission
SMEs	Small and medium enterprises
SMECN	Small and medium sized enterprises collection notes
SOEs	State-owned enterprises
SRO	Self-regulatory Organization