REGULATION OF CREDIT RATING AGENCIES IN TERMS OF CONFLICT OF INTEREST AND CIVIL LIABILITY IN EUROPEAN UNION

Avrupa Birliği'nde Kredi Derecelendirme Kuruluşlarının Çıkar Çatışması ve Hukuki Sorumluluk Açısından Düzenlenmesi

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Abstract

Credit rating agencies (CRA) have been evaluating the creditworthiness of financial instruments, issuers of these instruments and enterprises and providing ratings since the early 1900s. Ratings of CRAs indicate the risk of whether borrowers will fully repay the interests and principal at due time, thereby helping lenders and investors make the right decision.

Since CRAs have important role in the financial markets, it is expected that CRAs are not involved in conflicts of interest when providing rating. Conflicts of interest would affect the objectivity, impartiality and reliability of CRAs and thereby undermining the credibility and well-functioning of financial markets.

Following the financial crisis in 2008, European Union introduced some regulations and addressed all the problematic issues with CRAs. This essay addresses the European Union Regulation made in response to the global financial crisis in terms of conflict of interest and methods adopted to tackle this ongoing problem.

This essay's main purpose is to answer the research question of how it is possible to meet the burden of proof requirements for holding CRAs liable for the losses arising from conflict of interest and other breaches of CRA Regulation. Investor and issuers shall meet the burden of proof requirements in CRA Regulation Article 35a(1) and (2) to claim damages against CRAs. However, the provisions in CRA Regulation regarding burden of proof on civil liability requires high threshold to meet. Therefore, the allowance given to national courts to ease the claimants' burden of proof (Article 35a, point 2) is vital for claimants.

Key Words: Conflict of Interest, Civil Liability, Credit Rating Agencies

Özet

Kredi Derecelendirme Kuruluşları 1900'lü yılların başından bu yana finansal araçların, ihraç edenlerin ve işletmelerin kredibilitesini değerlendirmekte ve derecelendirme yapmaktadır. Bu derecelendirmeler, faizlerin ve anaparanın zamanında ve tam olarak geri ödeyip ödenmeyeceği riskini göstermekte ve böylece borç verenlerin ve yatırımcıların doğru kararı vermelerine yardımcı olmaktadır.

There is no requirement of Ethics Committee Approval for this study.

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Kredi derecelendirme kuruluşları finansal piyasalarda önemli bir role sahip olduklarından, derecelendirme yaparken çıkar çatışmasına girmemeleri gerekmektedir. Çıkar çatışmaları, derecelendirme kuruluşlarının tarafsızlığını ve güvenilirliğini etkileyebilmekte ve böylece finansal piyasaların güvenilirliğine ve işleyişine zarar verebilmektedir.

2008 yılındaki küresel ekonomik krizin ardından, Avrupa Birliği yeni tüzükler yayınlamış ve derecelendirme kuruluşlarına dair sorunlu konuları çözmeye çalışmıştır. Bu makale, küresel mali krize yanıt olarak getirilen Avrupa Birliği Tüzüğünü "çıkar çatışması" sorunu ve bu sorunu çözmek için benimsenen yöntemler açısından ele almaktadır.

Bu makalenin temel amacı, kredi derecelendirme kuruluşlarının, çıkar çatışması ve Tüzükte yer alan diğer ihlaller sebebiyle neden oldukları zararlardan sorumlu tutulabilmesi için yerine getirilmesi gereken ispat külfetini ilgili Tüzük hükümleri bağlamında ele almaktır. Yatırımcı ve ihraççılar, zararlarının tazmini için Tüzüğün 35a(1) ve (2) maddesinde belirtilen ispat yükü gerekliliklerini yerine getirmek zorundadırlar. Ancak, Tüzükte yer alan ispat yükü eşiği yüksek olup, davacıların ispat yükünü hafifletmek için ulusal mahkemelere verilen yetki [Madde 35a(2)] talep sahipleri için hayati önem taşımaktadır.

Anahtar Sözcükler: Çıkar Çatışması, Hukuki Sorumluluk, Kredi Derecelendirme Kuruluşları

INTRODUCTION

Credit rating agencies (CRA) are gatekeepers which play important role in ensuring integrity and stability in financial markets and contribute the development and the well-functioning structure of these markets, which is why they are essential for a resilient economy. CRAs have been evaluating the creditworthiness of financial instruments, issuers of these instruments and enterprises and providing ratings with regard to them since the early 1900s.[1] Ratings of CRAs indicate the risk of whether borrowers will fully repay the interests and principal at due time, thereby helping lenders and investors make the right decision. As there are an informational asymmetry and lack of full transparency which make risk evaluation more difficult in terms of investors and lenders, CRAs help mitigate these informational asymmetries, by providing information in the form of rating. These ratings help investors and lenders to predict the perils they might face when making financial decisions.[2]

Since CRAs are gatekeepers with reputational capital and as mentioned above have important role in the financial markets in terms of issuers and investors, it is expected that CRAs are not involved in conflicts of interest when providing rating. Conflicts of interest would affect the objectivity, impartiality and reliability of CRAs and thereby undermining the credibility and well-functioning of financial markets. Conflict of interest is also shown among the

1 Chiara Picciau, 'The Evolution of the Liability of Credit Rating Agencies in the United States and in the European Union: Regulation after the Crisis' (2018) 2 ECFR 339, 340

2 Harry McVea, 'Credit Rating Agencies, The Subprime Mortgage Debacle and Global Governance: The EU Strikes Back' (2010) 59 INT'L & COMP. L.Q 701, 706

triggers of the global financial crisis in 2008 and the leading CRAs called 'the big three' were harshly criticised for not providing independent ratings under "issuer-pays" model.[3]

Following the financial crisis in 2008, European Union (EU) introduced some regulations[4] and addressed all the problematic issues with CRAs in response to the crisis.[5] With these regulations, EU focused on reducing reliance on CRAs, increasing transparency and accountability, enhancing competition in the credit rating market, raising the quality of the rating process and especially civil liability of CRAs and reducing conflicts of interest.[6]

This article suggests that conflict of interest is one of the main problematic issues regarding credit rating and CRAs that negatively affect the efficiency and reliability of financial markets and even indirectly economies of countries as seen in global financial crisis in 2008. Therefore, it is very crucial to regulate this issue and to ensure good quality of credit ratings. In this context, this article addresses the EU Regulation on CRAs and the amending Regulations made following the global financial crisis in terms of conflict of interest and methods adopted to tackle this ongoing problem. Most importantly, this article aims to draw the readers' attention to the difficulty in proving conflict of interest and holding CRAs responsible for the losses they cause by applying the relevant EU Regulation, despite the regulations made in EU in order to tackle this issue in good faith. This essay's main purpose is to find the answer of the question of how it is possible to meet the burden of proof requirements for holding CRAs liable for the losses they cause on the basis of conflicts of interest and other breaches.

This article proceeds as follows:

Section 2 examines the concept of "conflict of interest" and the systemic role of CRAs in financial markets and the effects of these gatekeepers on the financial crisis in 2008. Section 3 deals with the EU Regulation introduced following the global financial crisis regarding CRAs in terms of the issue of conflicts of interest and addresses the methods adopted by the Regulation. Section 4 examines the issue of conflict of interest as an infringement leading

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3 Morten Kinander, 'Conflicts of interest in finance - Does regulation of them reduce moral judgment, and is disclosure harmful?'(2018) 26,3 JFRC 334, 336

4 Regulations are applicable and binding in all EU member states.

5 Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies [2009] OJEU L302/52; Regulation (EU) No 513/2011 of the European Parliament and of The Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies [2011] OJEU L145/30; Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on Credit Rating Agencies [2013] OJEU L146/1

6 See<https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/regulating-credit-rating-agencies_en> accessed 2 December 2021

to civil liability and includes opinions regarding the problematic issue of burden of proof. Section 5 concisely summarizes the conclusions reached.

1. The Systemic Role of CRAs In Financial Markets and the Issue of "Conflict of Interest"

The concept of 'conflict of interest' can broadly be defined as an incompatibility between personal interests and professional responsibilities that affects someone's actions, judgments, independence and impartiality.[7] This interest could be any interest that could compromise or negatively affect the independent judgment.[8]

The conflict of interest has been one of the main problems of credit rating system for a long time. CRAs play an important role in determining investor's decisions or lending decisions and therefore ratings should not be affected by the relationships between CRAs and their clients which are called conflict of interest.

Where companies need to raise fund and decide to issue debt securities, these issuers ask CRAs to rate their products to ensure that their securities become more marketable.[9] CRAs provide their opinions on the possibility that an issued debt security will perform in accordance with its terms and these ratings show how likely issuers are able to make its repayments.[10] Hence, even though credit ratings are not an indicator of a profitable investment, they are able to have decisive influence on potential investor's decision regarding purchase of issued debt securities and therefore a conflict of interest between CRAs and issuers which affects the good quality of rating may lead to investors' economic losses and disruption in financial markets. CRAs would be involved in conflict of interest if they provide too favourable rating with the expectation of entering into more rating contract with a client, which is against the best interest of the investors and the market.[11]

Also, where the ratings provided for borrowers are affected by a conflict of interest between CRAs and borrowers, it might influence the amount of loan borrowed and interest rate at which the loan will be paid off. In this case, as credit ratings are provided for the evaluation of counterparty risk, disruption of quality in ratings would be harmful for the financial institutions and the market.

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7 See <https://www.financial-ombudsman.org.uk/corporate/policies/conflicts-interest> accessed 6 December 2021

8 Kinander (n 3) 338.

9 International Organization of Securities Commissions (IOSCO) The Role of Credit Rating Agencies in Structured Finance Markets Final Report May 2008 <https:// www. iosco. org/ library/ pubdo cs/ pdf/ IOSCO PD638. pdf.> accessed 7 December 2021, 3

10 ibid 4.

11 Kinander (n 3) 346.

Ratings also help businesses assess the possibility of potential partnerships and other business relationships with the business provided rating.[12] Therefore, conflict of interest in rating contracts may negatively affect financial life.

In addition, after declaration of rating, CRAs keep tracking their clients' credit ratings and can update its rating, if necessary, based on new data. Therefore, the affects of conflict of interest may be long-lasting.

CRAs' role in the global financial crisis in 2008 and the issue of conflict of interest which is inherent in "issuer-pays model" are widely accepted by commentators.[13] It is argued that as CRAs always tend to create strong relationships with lucrative and well-known clients and then maintain these relationships, CRAs were more lenient at rating assets for these clients than for other customers before 2008.[14] With the help of CRAs' unsustainable credit ratings, issuers managed to issue financial instruments with the highest creditworthiness and met institutional investors' criteria to make investment in these securities[15] and created one of the factors of the financial crisis. As a result, even though there are other different factors in the crisis, CRAs are considered as one of the main contributors.[16]

2. EU Regulation on Credit Rating Agencies Following the Global Financial Crisis and the Issue of Conflicts of Interest

The first EU Regulation after global financial crisis was published in 2009 which is Regulation (EC) No 1060/2009 on CRAs.[17] With this regulation some problematic issues were addressed regarding CRAs, including conflict of interest. However, some issues remained unregulated such as civil liability, over-reliance on CRAs etc. Therefore, in 2013, Regulation (EU) No 462/2013[18] was published which amended Regulation (EC) No 1060/2009.[19] Within this

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12 See <https://www.spglobal.com/ratings/_divisionassets/pdfs/guide_to_credit_rating_essentials_digital.pdf> accessed 7 December 2021

13 Thomas M.J. Möllers and Charis Niedorf, 'Regulation and Liability of Credit Rating Agencies –A More Efficient European Law?' (2014) European Company and Financial Law Review 11 3 333,336; Picciau (n 1) 340.

14 Picciau (n 1) 383.

15 Thomas J. Pate, 'Triple-A Ratings Stench: May the Credit Rating Agencies be Held Accountable?' (2010) 14,1 Barry Law Review, 24, 31-32

16 Picciau (n 1) 354.

17 Regulation (EC) No 1060/2009 of the European Parliament and of the Council on Credit Rating Agencies [2009] OJEU L302/52

18 Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on Credit Rating Agencies [2013] OJEU L146/1

19 Francesco De Pascalis, 'Civil Liability of Credit Rating Agencies From a European Perspectıve: Development And Contents of Art 35(a) of Regulatıon (EU) No 462/2013' (2013) University of Oslo Faculty of Law Legal Studies Research Paper 2015-05, 1 <https://

Regulation there are some new rules regarding conflict of interest in addition to other subjects.

2.1 Issuer-Pays Model

Issuer-pays model is a remuneration model or business model in credit rating sector in which CRAs are paid in return for their ratings by issuers whose financial instruments are rated or by entities rated.[20] The fundemental benefit of this model is that as the cost is borne by issuers and entities, credit ratings are utilised by market participants freely.[21] However, this remuneration model also encourages building long-term client-CRA business relationships and CRAs may not remain impartial and may not keep their objectivity because issuers' and entities' payment are their main source of income.[22] CRAs tend to provide more favourable ratings to protect their business relationships with issuers and entities. Higher ratings would strenghten the possibility of ensuring getting additional rating work from issuers.[23] Also, in this model, issuers have leverage or bargaining power over CRAs to get higher ratings and undoubtedly CRAs perceive this monetary pressure and are highly likely impressed.[24]

Entities and issuers which want to get the most favourable ratings solicit ratings from different CRAs and select the highest one. This situation in practice leads to rating shopping and causes reduction in quality of ratings. Because, CRAs compromise their objectivity and impartiality in order to compete with the other CRAs.[25]

It can be clearly said that even though it is widely accepted that issuer-pays model deeply affects the good quality of credit ratings and might create negative results for investors since the global financial crisis, it still remains the predominant model.[26] This situation which is caused by the regulatory preference not cutting the relationships between CRAs and issuers obviously hinders the impact of the Regulation.[27]

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papers.ssrn.com/sol3/papers.cfm?abstract_id=2546756> accessed 7 December 2021

20 Tim Wittenberg, 'Regulatory Evolution of the EU Credit Rating Agency Framework' (2015) 16,4 EUR BUS ORG LAW REV 669, 677; European Commission, *Study on the State of the Credit Rating Market Final Report MARKT/2014/257/F4/ST/OP* (European Union, 2016) 10

21 European Commission (n 17) 10.

22 European Commission (n 17) 10.

23 Dori K. Bailey, 'The New York Times and Credit Rating Agencies: Indistinguishable under First Amendment Jurisprudence' (2016) 93, 2 Denver Law Review 275, 349

24 Steven L. Schwarcz, 'Private Ordering of Public Markets: The Rating Agency Paradox' (2002) 1 University of Illinois Law Review 1,15

25 European Commission (n 17) 20.

26 European Commission (n 17) 10.

27 Andreas Kruck, 'Resilient blunderers: credit rating fiascos and rating agencies' institutionalized status as private authorities' (2016) 23, 5 Journal of European Public

The EU Legislator, on the one hand allows CRAs to provide rating service on the basis of issuer-pays model, on the other hand tries to mitigate the flaws of this model. In this respect, the CRA Regulation requires that fees charged by CRAs for rating services shall not be determined depending on the rating grade or on any other result of the work performed.[28] These provisions aim at reducing possibility of conflicts of interest in order to protect investors.

2.2 Double Credit Rating and Maximum Duration of Rating Contracts

CRA Regulation requires the issuers and related third parties to solicit credit ratings from two or more CRAs and stipulates the conditions for these CRAs. However, this rule only applies to credit ratings for structured finance instruments.[29] In our view, even though the scope of this provision is limited to structured finance instruments, this double rating requirement can, to a certain extent, fix the reduction in quality of ratings based on conflict of interest resulting from issuer-pays business model because double rating mechanism ensures additional checking on ratings.

In addition, the CRA Regulation provides a requirement for the issuers to limit long term relationships between CRAs and issuers. For instance, the CRA Regulation requires a maximum period (4 years) for the issuance of solicited credit ratings on new re-securitisations with underlying assets from the same originator.[30] In other words, the CRA Regulation sets out a compulsory rotation rule requring issuers of structured finance products with underlying re-securitised assets to change the CRA every four years.[31] Inter alia, with this rule on rotation mechanism, the EU Legislator aims to mitigate conflicts of interest based on long-lasting contractual relationships, by strengthening the independence of CRAs towards issuers soliciting their ratings.[32] It is surely beyond doubt that as this mechanism applies only to new resecuritisations, its effect of preventing conflict of interest would take place to a limited extent.

2.3 Previous Advisory Services

The EU Legislator bans CRAs from providing consultancy or advisory services to issuers or related third parties regarding their corporate or legal structure, assets, liabilities or activities, considering the risk of losing impartiality of CRAs in rating activities towards the entities and related third

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Policy 753, 764

28 CRA Regulation, Annex I, Section B, point 3c.

29 CRA Regulation, art. 8c.

30 Wittenberg (n 17) 686-687.

31 See <https://ec.europa.eu/commission/presscorner/detail/fr/MEMO_13_13> accessed 12 December 2021

32 Wittenberg (n 17) 688.

parties which they previously provide consultancy and advisory.[33] The rule mentioned aims to help to mitigate the peril of conflict of interest resulting from "double-hatting" relationship with issuers.

In addition, in order to mitigate the conflict of interest and strengthen the market supervision by The European Securities and Markets Authority (ESMA)[34] in this sense, the EU Legislator provides a requirement for CRAs to prevent rating shopping of issuers.[35] In this respect, CRAs are required to notify ESMA information about all entities or debt instruments submitted to it for their initial review or for preliminary rating.[36]

2.4 Prohibitions on Credit Rating Service

The EU Legislator prohibits providing credit rating service where conflict of interest arising from various interest relationships such as shareholding or control may compromise the impartiality of the CRA. For instance, an issuer who is also shareholder in CRA and who can be effective in management of CRA could influence the CRA to provide favourable rating on his product.

The CRA Regulation addresses conflicts of interest and provides governance and internal procedures in Article 6a and details in Annex I regarding the situations based on shareholding or control relationships where a CRA shall not issue a credit rating or a rating outlook or shall, in the case of an existing credit rating or rating outlook, immediately notify where the credit rating or rating outlook is potentially affected.

3. The Issue of "Conflict of Interest" and Civil Liability of Credit Rating Agencies in EU

3.1 Legal Framework on Civil Liability of Credit Rating Agencies in EU

The first CRA Regulation numbered 1060/2009 did not address the issue of civil liability of CRAs directly. It only says that rating organizations could be held liable by national courts by applying their own national laws. Recital (69) of CRA Regulation numbered 1060/2009 clearly expresses that any claim against CRAs based on infringement of the provisions of this Regulation should be brought under the applicable national law. The first regulatory step on civil liability of CRAs at the level of EU was taken with the adoption of CRA

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33 CRA Regulation, Annex I, Section B, points 4 and 5.

34 The European Securities and Markets Authority (ESMA) is an independent EU Authority that aims to ensure the stability of the EU's financial system by protecting investors and promoting stable and orderly financial markets. ESMA is also the single direct supervisor of Credit Rating Agencies within the EU. See <https://www.esma.europa.eu/supervision/credit-rating-agencies/supervision> accessed 5 May 2022.

35 Wittenberg (n 17) 691.

36 CRA Regulation, Annex I, Section D, Part I, point 6.

Regulation numbered 462/2013 which is applicable in all member states.[37] EU Legislator, with this Regulation, aims to provide investors with a legal remedy to compensate their losses based on CRAs' flawed ratings.

As credit ratings have a remarkable influence on investor's investment decisions and on the demand for financial products, CRAs have a significant responsibility towards investors and issuers. However, there is not always a contractual relationship between CRAs and issuers rated on an unsolicited basis or investors on which issuers and investors base their claims against CRAs. Therefore, it is very important step to establish civil liability system and provide right of compensation for issuers and investors not requiring contractual relationship between the party suffering loss and the party commiting infringement.[38]

In this respect, CRA Regulation Article 35a(1) establishes the main principle that CRAs could be held liable against investors and issuers for the losses their infringements caused irrespective of whether there is a contractual relationship between the parties.[39] It clearly provides that CRAs can be held liable for committing, intentionally or with gross negligence, any of the infringements listed in Annex III of this Regulation having an impact on a credit rating and investors or issuers may claim damages against that CRAs for damage caused to it because of that infringement.

3.2 Breach of Rules on Conflict of Interest as an Infringement

According to CRA Regulation Article 35a(1), CRAs can only be liable for their infringements listed in Annex III. In Annex III which was introduced by Regulation (EU) no 513/2011 and later amended by Regulation (EU) no 462/2013, every infringement are spesificially provided. There is no general provision describing the infringements, since all relevant infringements ranging from breach of conflict of interest rules to violations of disclosure requirements which may cause civil liability of CRAs are provided in detail.[40] Investors and issuers who want to claim their damages against CRAs shall indicate that the CRA has committed an infringement and that that infringement had an impact on the credit rating issued on the basis of accurate and detailed information (Article 35a(2)).

In this respect, breach of conflict of interest rules provided in CRA Regulation are one of the infringements laid out in Annex III which might lead to CRAs to be held liable. Burden of proof of infringement based on conflict of interest shall be borne by investors as is in case of other infringements.

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37 Picciau (n 1) 384.
38 CRA Regulation (EU) no 462/2013, Recital (32).
39 CRA Regulation (EU) no 462/2013, Recital (32).
40 Picciau (n 1) 386.

In conclusion, CRAs could only be held liable for the infringements they commited intentionally or with gross negligence in accordance with the article 35a(1). According to article 35a(1) of the CRA Regulation, infringement with simple negligence is not a cause of action.

3.3 The Problematic Issue of Burden of Proof on Conflict of Interest

Investor and issuers shall meet the burden of proof requirements which are laid down in CRA Regulation Article 35a(1) and (2) in order to claim damages against CRAs. Investors shall prove three facts leading to liability of CRAs which are as follows;

1. Investors shall indicate that the CRA has committed an infringement of CRA Regulation and
2. Investors shall prove that the infringement mentioned had an impact on the credit rating issued and also
3. Investors are required to prove their reliance on credit rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating.

In addition, in terms of issuers' burden of proof there is an additional requirement. Accordingly, an issuer shall establish that the infringement was not caused by misleading and false information given by the issuer to the CRA, directly or through information publicly available.

After global financial crisis in 2008, investors tried to bring actions against CRAs for the losses they incurred. In response to this over-exposure to claims, CRAs, in order to defend themselves and suggest their non-liability, created a counter- argument that their ratings are only their opinions provided on a company's creditworthiness and it doesn't mean they absolutely assure credit quality and they don't recommend purchasing, holding or selling securities.[41]

Another obstacle to hold CRAs liable against investors and issuers were shown that it is hard to establish the liability of a CRA in the non-existence of a contractual relationship between a CRA and an investor or an issuer rated on an unsolicited basis.[42] In this respect, Article 35a have made it legally possible and acceptable to create casual link between credit rating and investors' and issuers' loss despite the lack of contractual relationships and also laid down the standards for causation and burden of proof.

However, in our view it can be said that the provisions in CRA Regulation regarding burden of proof of liability requires high threshold to meet by

[41] Jan De Bruyne, 'A European Perspective on the Liability of Credit Rating Agencies' (2018) 17, 2 Journal of International Business and Law 233, 233-234

[42] CRA Regulation (EU) no 462/2013, Recital (32).

investors and have some gaps in some matters. Being aware of this issues, EU Legislator prefered providing some alternative mechanism to mitigate these difficulties which will be examined below.

3.3.1 Proof of Conflict of Interest as an Infringement

According to article 35a, CRAs might be able to held liable for their infringements committed intentionally or with gross negligence and listed in Annex III having an impact on a credit rating. The same article also says that it is the resposibility of the investor or issuer to provide accurate and detailed information demonstrating that the CRA has committed an infringement and that infringement had an impact on the credit rating issued.

As it can be seen, first of all, issuers and investors are required to prove the infringement of this Regulation in terms of meeting burden of proof requirements. For instance, an investor who wants to make a claim against a CRA which commited an infringement concerning conflict of interest requirment placed in Point 7, Section I of Annex III to Regulation (EC) no 1060/2009, shall prove that that CRA commited the infringement set out in this particular provision. In other words, the investor shall prove that that CRA set up a compensation system for the independent members of its administrative or supervisory board which is linked to the business performance of the CRA. However, in practice, an investor probably might not be able to identify this kind of infringement because it is related to the company's internal compensation system and even though CRAs are under the requirement of disclousure of the general nature of its compensation arrangements, that compensation system linked to the business performance might be established de facto and only be detected in an administrative investigation. Even if the investor identify something wrong with the credit rating and inaccuracy in related rating, it is hardly possible to link this flawed rating with the infringement.

In this liability system, as can be seen that the burden of proof rests completely with the investor. The EU Legislator might have anticipated that reversal of the burden of proof could have considerably increased opportnities for investors and issuers to claim their damages, but in the mean time it would have also caused "flood of cases". Therefore, the EU Legislator reached the solution that the burden of proof rests on investors, but national courts have some discretionary power in determining what and how detailed the damaged party must allege and prove the infringement, taking into consideration that the investor or issuer may not have access to information which is absolutely under the control of the CRA.[43]

[43] Picciau (n 1) 387-388.

When it comes to moral element of the infringement, there is no clarity in CRA Regulation on who would bear the burden of proof on moral element. But, considering the general principles of law, the party who bears the burden of proof on the illegality (infringement), damage and causation would bear the burden of proof on moral element and therefore in our case, we can say that investors and issuers shall prove the intentional infringement or infringement with gross negligence. However, there is an exceptional provision in CRA Regulation which expresses that matters regarding the civil liability of a CRA which are not addressed by this Regulation shall be governed by the applicable national law as determined by the relevant rules of private international law.[44] That is why, burden of proof on moral element of infringement shall be determined by applicable national law.

3.3.2 Proof of Infringement's Impact on the Issued Rating

Investors and issuers shall prove not only the existence of the infringement but also the impact of the infringement on the rating issued [Article 35a(2)]. According to Article 35a, the party who is damaged is required to prove the infringement, for instance the infringement of a rule relating to conflict of interest, and also to prove that the infringement of the rule on conflict of interest affected the rating process in a way that resulted in an incorrect credit merit assessment and to indicate how that took place in the spesific situation.[45] In other words, the party incurred loss shall establish the link between the infringement and its impact on rating.

However, it doesn't seem that easy to connect the infringement to the rating's inaccuracy, because the only information the investors have is the information disclosed by CRAs in accordance with the regulatory obligations. Even though the disclosure requirements of CRAs are helpful to claim damages, its effectiveness is limited, since such information doesn't suffice for the proof that a particular infringement caused a specific rating inaccuracy which, in turn, leads to individual loss incurred. In other words, although disclosure requirements of CRAs absolutely help investors claim damages against CRAs, they do not include in detail all the potentially significant aspects of the rating process.[46] For instance, it is almost impossible to prove that the CRA has failed to ensure that a staff who is involved in rating doesn't accept money, gifts or favours from anyone with whom the CRA does business and also this infringement of the rule regarding conflict of interest has caused a specific rating inaccuracy which, in turn, has leaded to individual loss in particular case. Also in some cases, even

44 CRA Regulation, art. 35a, point 4.
45 Picciau (n 1) 388.
46 Picciau (n 1) 388.

though investors can identify the inaccuracy in credit rating, they might not be able to figure out which infringement caused the loss.

Therefore, the allowance given to national courts to ease the claimants' burden of proof (article 35a, point 2) is vital to grant investors an effective remedy. Otherwise, the relevant rules regarding burden of proof might turn out to be very difficult for the injured party and this right to claim damages which is granted to investors would be meaningless.[47]

Finally, in this respect, it can be stated as a solution for a more effective civil liability system that explicitly providing investors with right to use ESMA's sanctioning decisions and also it's findings regarding infringements of CRAs to meet their burden of proof could help mitigate the difficulties of Article 35a because when compared to investors who may not have access to information concerning how the rating service has been provided in a particular case, ESMA is authorized to use significant investigative powers such as requesting documents, conducting interview that could lead to detect an infringement more easily.[48]

3.3.3 Proof of Reliance on Rating

Investors can claim damages only if their investment decision was based on the credit rating issued and if such reliance was reasonably exercised. Investors, inter alia, shall prove that they acted reasonably when relying on the rating.[49] This reliance shall be exercised for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating. In our view, this requirement establishes the link between loss incurred by investor and the rating. "Reliance" establishes the causal link which is a condition for liability of the CRA.

This requirement shall be met differently in terms of institutional investors. The reliance threshold for institutional investors is higher than the one for private investors, because, according to article 5a, all entities listed in article 4 (1) have to make their own risk assessments and may not solely or automatically rely on other credit ratings. Therefore, CRAs would be liable to institutional investors less often than to private investors.[50] Private investors don't have to make their own risk assessment. They only have to indicate that they reasonably relied on the rating.[51]

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47 Picciau (n 1) 388.

48 Picciau (n 1) 397-400.

49 Möllers and Niedorf (n 12) 347.

50 Matthias Lehmann, 'Civil Liability of Rating Agencies: An Insipid Sprout from Brussels' (2016) 11, 1 Capital Markets Law Journal 60, 64

51 Möllers and Niedorf (n 12) 347.

Article 35a(1) of CRA Regulation provides that reliance on rating shall be placed for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating in order to hold CRAs liable. However, there is no clarity regarding how reliance is exercised in CRA Regulation. According to Article 35a, the term 'reasonably relied', shall be interpreted and applied under the applicable national law**.**

Finally, in order to ease the burden of proof, it is expressed by some scholars that requiring investors to prove reliance on rating might be penalizing and therefore it should be allowed by applicable national laws [in the context of both Article 35a(4) and 35a(5)] that investors can establish causal link or reliance by merely demonstrating that the inaccurate credit rating untruly changed the price of the financial products or represented a necessary precondition for the trade of the instruments on the market which means without the rating the financial instrument would not be marketable**.**[52]

3.4 Recent Trends and Developments on Civil Liability of CRAs in EU

CRA Regulation entered into force in 2013. However, until now, decisions holding CRAs liable are very rare in EU. These are not decisions made by applying CRA Regulation either.

It was reported recently that the Berlin Court, in May 2020, ruled in favour of investors who claimed its damages against a German CRA for the breach of a duty of care for a bond rating. The Court based it's decisions on German national law rather than CRA Regulation, since the bond had already been rated before CRA regulation entered into force.[53] This decision may be interpreted positively since it is a step forward in terms of judicial approach towards CRA liability. It is also positive development to make an assessment and attemp to apply CRA Regulation by the Court to the case on CRA liability and then to apply national law instead which is also provided and encouraged in Article 35a(5) of CRA Regulation.

In 2018, the Higher Regional Court of Düsseldorf ruled that Article 35a does not establish any liability of a CRA towards the investor if its rating relates to the issuer of the financial instrument bought by the investor but not to the financial instrument itself.[54] Even though the Court didn't ruled the existence of liability of the CRA, this decision can also be considered important, since the Court acknowledged that Article 35a applies to liability of CRA arising from its rating activities.

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52 Picciau (n 1) 391.

53 See<https://www.allenovery.com/en-gb/global/news-and-insights/publications/first-german-decision-holding-credit-rating-agency-liable-to-investors> accessed 19 December 2021.

54 OLG Düsseldorf, Urteil vom 08.02.2018 - I-6 U 50/17

To conclude, it can be said that investors have started bringing their claims against CRAs and in the near future we can see the decisions holding CRAs liable for their flawed ratings.

CONCLUSION

The issue of conflict of interest has been one of the biggest problems of credit rating system for a long time. CRAs play an important role in determining investor's decisions or lending decisions and therefore ratings shouldn't be affected by conflict of interest.

The role of CRAs in the global financial crisis in 2008 and the issue of conflict of interest originating from "issuer-pays model" are widely accepted. It is argued that as CRAs always tend to create strong relationships with lucrative clients, CRAs were more lenient at rating assets for these clients than for other customers before 2008.

The first EU Regulation on CRAs [Regulation (EC) No 1060/2009] following the global financial crisis was published in 2009. With this regulation some problematic issues was adressed, including conflict of interest. In 2013, Regulation (EU) No 462/2013 was published which amends Regulation (EC) No 1060/2009. This Regulation, inter alia, includes the rules on civil liability of CRAs. With this regulation, EU Legislator aims to provide investors and issuers with an opportunity to compensate their losses arising from CRAs' ratings. It is accepted as a very important step to establish civil liability system and provide right of compensation for issuers and investors, not requiring contractual relationship between the party suffering loss and the party commiting infringement.

In this respect, CRA Regulation Article 35a(1) clearly provides that CRAs can be held liable for committing, intentionally or under gross negligence, any of the infringements listed in Annex III of this Regulation having an impact on a credit rating and investors or issuers may claim damages against that CRAs for damage caused to it due to that infringement.

Investor and issuers shall meet the burden of proof requirements which are laid down in CRA Regulation Article 35a(1) and (2) in order to claim damages against CRAs. However, in our view, the provisions in CRA Regulation regarding burden of proof on civil liability requires high threshold to meet by investors. Therefore, the allowance given to national courts to ease the claimants' burden of proof (article 35a, point 2) is vital for investors in terms of having an effective remedy. Otherwise, the relevant rules regarding burden of proof might turn out to be very difficult for the damaged party and this right to claim damages which is granted to investors would be meaningless.

In addition, it can be stated as a solution for a more effective civil liability system that explicitly allowing investors to rely on ESMA's sanctioning decisions and also it's findings regarding infringements of CRAs to meet their burden of proof could help mitigate the difficulties of Article 35a because when compared to investors who may not know how the rating service has been performed in a particular case, ESMA is authorized to use significant investigative powers such as requesting documents, conducting interview that could lead to detect an infringement more easily.

Amendments to CRA Regulation regarding civil liability entered into force in 2013, however, so far, decisions holding CRAs liable are very rare in EU. These are not decisions made by applying CRA Regulation either. But, neverthless, these decisions can also be considered important, since the Courts acknowledged that Article 35a applies to liability of CRA arising from its rating activities.

Finally, it can obviously be seen that investors have started bringing their claims against CRAs and in the near future we will be able to see the decisions on civil liability of CRAs.

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