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## REGULATION OF CREDIT RATING AGENCIES IN INDIA

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This Report is an independent, non-commissioned piece of academic work.

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## I. INTRODUCTION

Credit rating is an opinion of a recognised entity on the relative creditworthiness of an issuer or instrument. In other words, it is an informed opinion “*on the relative degree of risk associated with timely payment of interest and principal on a debt instrument*”.<sup>1</sup>

The business of credit rating started in the early 1900s, with John Moody’s rating of rail bonds. Over the last century, credit rating has evolved into a sophisticated business. Today, this involves rating of not just simple and complex debt instruments of commercial entities, but also sovereign debt.<sup>2</sup> Globally, a vast majority of this business is conducted by three credit rating agencies (‘CRAs’)- Moody’s, Standard & Poor’s and Fitch.

In India, the business of credit rating was first started in 1987 by large financial institutions and creditors through CRISIL. In the last 30 years, seven CRAs have been established,<sup>3</sup> with the most influential ones being owned by Moody’s, Standard & Poor’s and Fitch.<sup>4</sup> CRAs have now become an essential part of the Indian financial system. They are regulated by the Securities and Exchange Board of India (‘SEBI’) through the SEBI (Credit Rating Agencies) Regulations, 1999 and circulars issued under it. However, in the last few years, the adequacy of this regulatory framework has come into question. This report aims to address this question.

This report examines the process and role of credit ratings in the financial system and analyses the regulatory regime for CRAs in India. Thereafter, it highlights the main concerns regarding the regulation of CRAs in India. Ultimately, this report collates international practice on the regulation of CRAs, and makes recommendations to improve the regulation of CRAs in India.

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<sup>1</sup> Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies* (2009), 13.

<sup>2</sup> Lawrence J. White, ‘Markets: The Credit Rating Agencies’, *Journal of Economic Perspectives* (2010) 24(2), 211, 226.

<sup>3</sup> SEBI, *Name & Registered Addresses of Credit Rating Agencies*, available at <http://www.sebi.gov.in/commondata/recognised/Registered-Credit-Rating-Agencies.pdf>.

<sup>4</sup> Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies* (2009), 12.

## II. CREDIT RATINGS: PROCESS, ROLE, NEED FOR REGULATION

### A. Rating process

Credit ratings, issued by CRAs are publicly available assessments on whether instruments would be able to perform in accordance with the terms of their issue.<sup>5</sup>

CRAs typically rate

- debt securities;
- short term debt instruments, like commercial papers;
- structured debt obligations;
- loans; and
- fixed deposits.<sup>6</sup>

Companies seeking to raise debt (issuers) request a rating from the CRA. They then sign a rating agreement, which provides the terms of the CRA's engagement and gives the CRA access to the issuer's information. The CRA then assigns a 'Rating Team' to the company. This team collects information from the company, and conducts meetings with its management. Based on this, the team prepares a report of the risks associated with the company. This report is presented to a separate 'Rating Committee' which makes the rating decision. The Rating Committee is composed of a group of experts, who do not interact with the company directly. The rating decision is then communicated to the company. If the company accepts the rating decision, it is published. The CRA then periodically surveys the company and updates the rating decision through the period of the rating agreement. However, if the company chooses to reject the rating decision, CRAs typically provide for an appellate mechanism. If the rating is rejected after the appeal, such a rating is classified as an unaccepted rating.<sup>7</sup> All ratings, regardless of whether they are accepted or unaccepted have to be disclosed by CRAs.<sup>8</sup>

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<sup>5</sup> Jennifer Payne, 'The Role of Gatekeepers' in N. Moloney, E. Ferran and J. Payne (eds.), *Oxford Handbook of Financial Regulation* (OUP 2014), 254.

<sup>6</sup> *Id.*

<sup>7</sup> See: CRISIL, CRISIL's Rating Process (2017), ([https://www.crisil.com/Ratings/Brochureware/RR\\_ASSES/CRISIL-Ratings-research-rating-process\\_2013.pdf](https://www.crisil.com/Ratings/Brochureware/RR_ASSES/CRISIL-Ratings-research-rating-process_2013.pdf)); ICRA, Rating Process, (<https://www.icra.in/Rating/Process>)

<sup>8</sup> Securities and Exchange Board of India, Enhanced Standards for Credit Rating Agencies (CRAs) (2016), SEBI/HO/MIRSD/MIRSD4/CIR/P/2016/119.

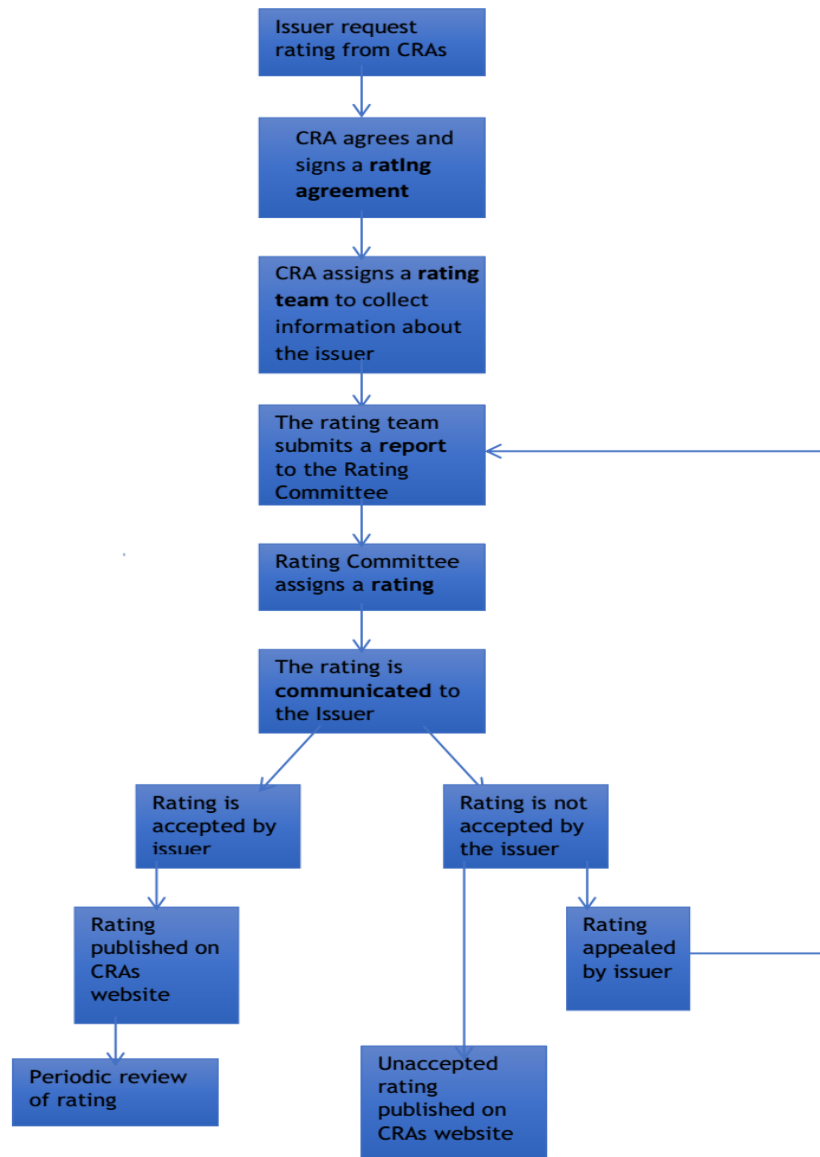


Fig. 1: Process of carrying out credit ratings in India

## B. Role of CRAs

CRAs play an important role in modern financial systems.

Their primary role is to reduce information asymmetry in credit markets by providing investors an opinion on the ability of an instrument to meet its obligations. Since CRAs get access to the management of the company, and confidential information about its working, they argue that they provide a more informed opinion. In addition, their investigation into affairs of companies is likely to reduce duplication of efforts by different persons in determining the creditworthiness of a debt

instrument.<sup>9</sup> Thus, investors who rely on such ratings benefit from reduced informational asymmetries and costs associated with determining the credit worthiness of issuers.<sup>10</sup>

CRA also have utility for issuers. They encapsulate extensive information relating to the debt instrument and issuer in rating symbols, and also lend some of their reputational capital to the issue. The issuer is thus able to concisely communicate the quality of their issue and indicate to the market that an independent assessment has been made regarding the creditworthiness of the issued instrument.<sup>11</sup> Thus, issuers of rated securities benefit from the wider access granted by suitable credit ratings to the market of investors.

Finally, CRAs function as gatekeepers for financial markets, and provide tangible benefits to financial market regulators by reducing the costs of regulation.<sup>12</sup> Regulators such as RBI use CRAs to improve the awareness and decision-making of their regulated entities. For instance, credit ratings are used to determine the capital adequacy of banks,<sup>13</sup> the resolution of stressed assets,<sup>14</sup> etc. As such CRAs have been ‘hardwired’ into the financial system in several jurisdictions and financial actors are legally bound to acquire ratings from CRAs while undertaking specific types of transactions.<sup>15</sup> Some financial regulators mandate that certain instruments must be rated mandatorily before they are issued. Others require their regulated entities to only invest in rated securities. Various commentators argue that this extensive integration of CRAs into the financial system transforms their role from financial gatekeepers to purveyors of regulatory licenses.<sup>16</sup>

Since they play such an important role in financial markets, there is a greater need to ensure that credit ratings are regulated in an appropriate manner, and are as reliable as they are influential.

### C. Need for regulation

Despite the immense utility of credit ratings, doubts have been cast on their reliability and accuracy.

<sup>9</sup> United Nations Conference on Trade and Development, *Credit Rating Agencies and their Potential Impact on Developing Countries* (Discussion Paper, No.128, 2008),2.

<sup>10</sup> World Bank Group, *Credit Rating Agencies* (2009), available at <http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1303327122200/Note8.pdf> at 1.

<sup>11</sup> Jennifer Payne, ‘The Role of Gatekeepers’ in N. Moloney, E. Ferran and J. Payne (eds.), *Oxford Handbook of Financial Regulation* (OUP 2014), 259.

<sup>12</sup> Robert J. Rhee, *Why Credit Ratings Exist*, Economic Notes by Banca Monte dei Paschi di Siena SpA, Vol. 44, No. 2 (2015) available at <http://onlinelibrary.wiley.com/doi/10.1111/ecno.12034/pdf> at 164.

<sup>13</sup> RBI, Master Circular on Basel III Capital Regulations (2015), RBI/2015-16/58.

<sup>14</sup> RBI, Reserve Bank of India Outlines the action plan to implement the Banking Regulation (Amendment) Ordinance, 2017, Press Release: 2016-2017/3138.

<sup>15</sup> See for instance, Securities and Exchange Commission, *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets* (January 2003) available at <https://www.sec.gov/news/studies/credratingreport0103.pdf> at 28. See also, Aline Darbellay and Frank Partnoy, *Credit Rating Agencies and Regulatory Reform*, University of San Diego, Legal Studies Research Paper Series-Paper No. 12-83 (2012), available at <http://ssrn.com/abstract=2042111> at 1-2.

<sup>16</sup> See: Aline Darbellay & Frank Partnoy, *Credit Rating Agencies and Regulatory Reform* (Legal Studies Research Paper, No.12-083, 2012), 1.

Critics argue that CRAs suffer from heavy conflicts of interest since they are hired by issuers themselves, to rate their instruments. This is exacerbated by their heavy reliance on the information provided by issuers,<sup>17</sup> which means that CRAs are not able to provide independent opinions on the actual credit worthiness of the instruments rated.

It is also argued that CRAs often lag behind market indicators. They believe that while initial ratings tend to be accurate, CRAs do not maintain adequately updated ratings. However, CRAs argue that this is because they present a more long-term view of the prospects of repayment in comparison to market indicators, such as the price of bonds.<sup>18</sup>

Moreover, critics argue that since credit ratings can provide regulatory licenses, they tend to create distortions in the market.<sup>19</sup> For instance, some argue that CRAs may provide minimum required ratings to issuers, for their issues to be valid to maintain long-term relationships.<sup>20</sup>

Despite inherent risks with credit ratings, CRAs were not comprehensively regulated in developed countries till the advent of the global financial crisis in 2007.<sup>21</sup> In the aftermath of the crisis, there was widespread recognition that CRAs were complicit in the advent of the crisis.<sup>22</sup> Critics argued that CRAs failed to estimate the market risk associated with the structured credit products correctly and thus, were unable to adjust the credit ratings accordingly.<sup>23</sup> This made regulators in developed markets review the regulatory framework governing CRAs, and introduce more stringent regulation of CRAs since the crisis.<sup>24</sup>

In the aftermath of the global financial crisis, SEBI also set up a Committee to review the regulatory framework for CRAs in India. Given that in 2009, India still had one of the most extensive regulatory frameworks for CRAs, and since there was little evidence of systemic misconduct by CRAs in the country, the Committee did not suggest large-scale reforms to this framework.<sup>25</sup>

<sup>17</sup> Dimitar Rafailov, 'The Failures of Credit Rating Agencies during the Global Financial Crisis- Causes and Possible Solutions', *Economic Alternatives* (2011) 1, 34, 37.

<sup>18</sup> National Institute of Securities Market, *Assessment of Long Term Performance of Credit Rating Agencies in India* (2009) ([http://www.sebi.gov.in/sebi\\_data/attachdocs/1288587929503.pdf](http://www.sebi.gov.in/sebi_data/attachdocs/1288587929503.pdf)).

<sup>19</sup> Aline Darbellay & Frank Partnoy, *Credit Rating Agencies and Regulatory Reform* (Legal Studies Research Paper, No.12-083, 2012), 20.

<sup>20</sup> National Institute of Securities Market, *Assessment of Long Term Performance of Credit Rating Agencies in India* (2009) ([http://www.sebi.gov.in/sebi\\_data/attachdocs/1288587929503.pdf](http://www.sebi.gov.in/sebi_data/attachdocs/1288587929503.pdf)).

<sup>21</sup> Jonathan Katz, Emanuel Salinas, and Constantinos Stephanou, 'Credit Rating Agencies: No Easy Regulatory Solutions', (2009) 8 *Crisis Response: Public Policy for the Private Sector*, 1,2.

<sup>22</sup> *Id* at 1; Siegfried Utzig, 'The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective', (2010) 188, ADBI Working Paper Series 1,1, (<https://www.adb.org/sites/default/files/publication/156043/adbi-wp188.pdf>).

<sup>23</sup> Siegfried Utzig, 'The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective', (2010) 188 ADBI Working Paper Series 1,1 (<https://www.adb.org/sites/default/files/publication/156043/adbi-wp188.pdf>).

<sup>24</sup> Edmund Parker and Miles Bake, 'Regulation of credit rating agencies in Europe', July/August 2009 *Butterworths Journal of International Banking and Financial Law* 401,401., ([https://www.mayerbrown.com/public\\_docs/jibfl\\_ju\\_parker.pdf](https://www.mayerbrown.com/public_docs/jibfl_ju_parker.pdf)); 'Credit Rating Agencies' (*U.S. Securities and Exchange Commission*) (<https://www.sec.gov/spotlight/dodd-frank/creditratingagencies.shtml>).

<sup>25</sup> Ministry of Finance, Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies* (2009).



However, in the period after, concerns have been raised regarding the regulation of CRAs in the country. One recent case that has brought CRAs under the scanner is the case of Amtek Auto. Here certain CRAs allegedly suspended and withdrew the ratings of Amtek as it was on the verge of defaulting in repayment of bonds, without following due procedure.<sup>26</sup> Before this Amtek had highest ratings in bonds and overnight these securities lost much of their value, adversely affecting the investors.<sup>27</sup>

Moreover, one study analysed 248 companies of the BSE and concluded that a gap existed between the credit ratings issued to different companies and their financial ratios, raising doubts regarding the correctness of these ratings. Critics blame this on the competition among these CRAs and the virtual rating shopping that issuers indulge in.<sup>28</sup> Another study indicates that problems in ratings could have contributed to the rising non-performing assets (NPA) crisis of India.<sup>29</sup> The study analysed the ratings of 10 corporate groups which were responsible for 20% of all distressed loans from FY 11 to FY 16. In FY 10 the total debt for these corporate groups amounted to Rs 3 lakh crore which jumped to Rs 7 lakh crore by FY 14. During FY 11 to FY 13, each one of these corporates were given a rating in the 'No Risk' or 'Low Risk' category and it was only in FY14 that the rating was downgraded for some of them, when they had already started defaulting. Thus, this study concluded that the inaccuracy of these ratings could have contributed significantly to the NPA crisis in India.<sup>30</sup>

Such incidents have raised concerns for the need to regulate CRAs better. In the following chapters, we will evaluate the regulatory regime for CRAs in India and attempt to shed light on the concerns that should be addressed.

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<sup>26</sup> Jayshree P. Upadhyay, 'CARE, Crisil may face Sebi action in Amtek Auto case' (*Live Mint*, 22 June 2016) (<http://www.livemint.com/Money/wCOP9C63UmWFle4X6pgsyK/Amtek-Auto-case-Sebi-may-take-action-against-CARE-Crisil.html>).

<sup>27</sup> 'NPA crisis: Given rating agencies track record, odd that RBI looks to add to their credibility' *Financial Express* (25 May 2017) (<http://www.financialexpress.com/opinion/npa-crisis-given-rating-agencies-track-record-odd-that-rbi-looks-to-add-to-their-credibility/684452/>).

<sup>28</sup> Krishna Kant, 'How reliable are companies' credit ratings?' *Business Standard* (Mumbai, 27 August, 2014.) ([http://www.business-standard.com/article/companies/how-reliable-are-companies-credit-ratings-114082600845\\_1.html](http://www.business-standard.com/article/companies/how-reliable-are-companies-credit-ratings-114082600845_1.html)).

<sup>29</sup> Praveen Chakravarty, 'The Silent Role of Credit Ratings in India's Bad Loan Crisis' *Bloomberg Quint* (8 July, 2016) (<https://www.bloombergquint.com/opinion/2016/07/08/the-silent-role-of-credit-ratings-in-indias-bad-loan-crisis>).

<sup>30</sup> *Id.*

### III. REGULATORY REGIME FOR CREDIT RATING AGENCIES IN INDIA

In India, CRAs are regulated by the Securities Exchange Board of India SEBI.<sup>31</sup> SEBI was one of the first regulators globally, to put forth a comprehensive framework for the regulation of CRAs through the SEBI (Credit Rating Agencies) Regulations, 1999 ('CRA Regulations').<sup>32</sup>

The CRA Regulations cover the following areas-

- **Registration:** Broadly, the CRA Regulations require that CRAs should be companies promoted by persons who have experience in the field of credit rating i.e., by financial institutions or by persons who have a net-worth of more than 100 crore rupees.<sup>33</sup> CRAs need to have a minimum net-worth of 5 crore rupees, and adequate infrastructure, professionals and employees to carry on the activity of issuing credit ratings. Additionally, registration would only be granted if it registering the applicant is in the interest of investors and the securities market.<sup>34</sup>
- **Obligations:** The CRA Regulations envisage that CRAs need to carry out their activities in accordance with the terms of their engagement with the issuer,<sup>35</sup> and the baseline principles in the Regulations. CRAs have to comply with the Code of Conduct prescribed by SEBI, which requires that they discharge their duties with integrity, professional competence, independence and confidentiality.<sup>36</sup> In addition, CRAs are required to monitor their rating throughout the lifetime of the securities rated and carry on periodic reviews of their rating as well.<sup>37</sup>
- **Disclosure:** The CRA Regulations require CRAs to maintain and disclose their ratings in a specified manner.<sup>38</sup> They require that CRAs should maintain copies of their rating notes, ratings issued, terms of engagement, records of decisions of rating committees and fees charged for ratings for at least five years.<sup>39</sup>
- **Conflict of interest:** The Regulations attempt to reduce conflicts of interest. They require that CRAs may not rate securities that are issued by their promoters or their associates.<sup>40</sup> In

<sup>31</sup> Securities and Exchange Board of India, 1992, sec 11(2)(ab).

<sup>32</sup> CRAs are also subject to other regulations including the Securities and Exchange Board of India (Intermediaries) Regulations, 2008.

<sup>33</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, reg 4.

<sup>34</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, reg 5.

<sup>35</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, reg 14.

<sup>36</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, reg 13, Third Schedule.

<sup>37</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, regs 15, 16.

<sup>38</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, regs 24.

<sup>39</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, reg 21.

<sup>40</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, ch IV.

addition, CRAs must also maintain an arm's length relationship between credit rating activities and other activities.<sup>41</sup>

- **Accountability and Enforcement:** The Regulations require that CRAs should have an internal audit,<sup>42</sup> submit information to SEBI whenever required,<sup>43</sup> and be open to inspection and investigation by SEBI.<sup>44</sup> They also specify that CRAs may be held liable for any contravention under the SEBI Act, or any of the Rules or Regulations as specified in them. Alternatively, they may be held liable under Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008.

Till 2008, the regulatory framework for CRAs did not undergo any significant changes. However, in the aftermath of the global financial crisis, in which CRAs were considered complicit, a 'Committee on Comprehensive Regulation for Credit Rating Agencies' was constituted to review the regulatory framework. The Committee concluded that "*prima facie, there is no immediate concern about the operations and activities of CRAs in India even in the context of the recent financial crisis. However, there is a need to strengthen the existing regulations by learning the appropriate lessons from the current crisis.*"<sup>45</sup> Thereafter, SEBI has introduced several changes to the regulatory framework for CRAs.

In 2010, SEBI issued circulars overhauling its regulatory framework, on taking note of the pivotal role of CRAs in the financial markets and the importance of transparency by CRAs. SEBI issued circulars laying down detailed requirements for the internal audit of CRAs and prescribing enhanced disclosures to be made by CRAs. SEBI required CRAs to disclose default matrices of securities as well as preserve explanatory notes for each rating or surveillance conducted by them.<sup>46</sup>

Thus far, SEBI regulated only the rating of debt securities. However, CRAs rated a vast variety of instruments, including bank loans, overdraft facilities, letters of credit. All of these rating activities remained unregulated. However, in 2012, SEBI issued a circular stating that that CRAs would "*follow the applicable requirements pertaining to rating process and methodology and its records, transparency and disclosures, avoidance of conflict of interest, code of conduct, etc., as prescribed in the Regulations and circulars issued by SEBI from time to time*" for rating of other instruments as well.<sup>47</sup>

In 2016, SEBI issued a circular laying down guidelines to enhance the standards followed by CRAs and improve transparency in their policies. This circular requires CRAs to publicly disclose their rating criteria and rating processes, standardise press releases for rating actions, disclose rating both in case of non-acceptance by issuers and non-cooperation by issuers and disclose a delay in

<sup>41</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, cl 18 Third Schedule.

<sup>42</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, reg 22.

<sup>43</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, reg 19.

<sup>44</sup> Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, ch V.

<sup>45</sup> Ministry of Finance Capital Markets Division, *Report of the Committee on Comprehensive Regulation for Credit Rating Agencies* (2009), 12.

<sup>46</sup> Securities and Exchange Board of India, Internal Audit for Credit Rating Agencies (CRAs), SEBI/MIRSD/CRA/Cir-01/2010; Securities and Exchange Board of India, Guidelines for Credit Rating Agencies, CIR/MIRSD/CRA/6/2010.

<sup>47</sup> Securities and Exchange Board of India, Guidelines for Credit Rating Agencies, CIR/MIRSD/3/2012. The validity of this circular is discussed in Ch. IV.

periodic review of ratings. In addition, the circular requires CRAs to impose accountability on rating analysts, and improve the functioning and evaluation of rating committees.<sup>48</sup>

Despite the consistent strengthening of the regulatory regime in India, some concerns regarding the regulation of CRAs persist. These will be explored in the next chapter.

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<sup>48</sup> Securities and Exchange Board of India, Enhanced Standards for Credit Rating Agencies (CRAs) (2016), SEBI/HO/MIRSD/MIRSD4/CIR/P/2016/119.

## IV. CONCERNS REGARDING THE REGULATION OF CREDIT RATING AGENCIES

### A. Removing Conflicts of Interest

Typically, CRAs are hired by issuer entities to rate the securities being offered, and are remunerated once this task is completed. This model of remuneration is called the ‘issuer pays’ model. Since CRAs are dependent on issuers for the payment of their fees, although their main role in the market is to serve investors, a greater possibility of a conflict of interests arises.<sup>49</sup> This is because the “*there are incentives for credit rating agencies to issue complacency ratings on the issuer in order to secure a long-standing business relationship in order to guarantee revenues or to secure additional work and revenues.*”<sup>50</sup>

While the issue of conflict of interest, due to the ‘issuer-pays’ model, may arise in respect of other gatekeepers in the financial markets, the potential of conflict and associated harms is likely to be higher in case of CRAs. This may be due to the following:

- **Lack of competition in the market:** This enables CRAs to have longer, well- established relationships with the issuers.<sup>51</sup> As such, this allows CRAs, their employees, and analysts to get so familiar with the issuer that their independence may be affected, further exacerbating the inherent conflict.<sup>52</sup>
- **Gatekeeper role of CRAs:** As discussed previously, CRAs are supposed to reduce information symmetry in the market for investors. Thus, they have a kind of ‘watchdog’ role in the market, which is further ‘hardwired’ by the regulatory mandate of ratings in specific cases.<sup>53</sup>

Given this, SEBI, like other regulators across the globe, has adopted detailed rules to prevent specific kinds of conflict, for instance conflicts arising from providing non-rating activities to rated issuers, conflicts of ownerships etc. However, this approach creates endless tasks for the regulator, since each time one conflict is suppressed, another one springs up.<sup>54</sup> Moreover, no specific instance of conflict can be entirely eliminated either since the underlying causes of conflict are not addressed. To illustrate, although the CRA regulations prohibit CRAs from offering non-rating

<sup>49</sup> Jennifer Payne, ‘The Role of Gatekeepers’ in N. Moloney, E. Ferran and J. Payne (eds.), *Oxford Handbook of Financial Regulation* (OUP 2015), 263.

<sup>50</sup> Recital 11, Council Regulation 462/2013 of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies [2013] OJ L146/1.

<sup>51</sup> Jennifer Payne, ‘The Role of Gatekeepers’ in N. Moloney, E. Ferran and J. Payne (eds.), *Oxford Handbook of Financial Regulation* (OUP 2015), 275.

<sup>52</sup> Recital 13, Council Regulation 462/2013 of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies [2013] OJ L146/1.

<sup>53</sup> Jennifer Payne, ‘The Role of Gatekeepers’ in N. Moloney, E. Ferran and J. Payne (eds.), *Oxford Handbook of Financial Regulation* (OUP 2015), 275.

<sup>54</sup> *Id* at 265.

services, other than research, a study<sup>55</sup> points to evidence suggesting the prevalence of conflict of interest possibly due to non-rating services provided by CRAs in India. The study reveals that issuers who took non-rating services from a CRA were generally assigned higher ratings by the CRA in comparison to the rating assigned by other CRAs. Additionally, issuers who provided greater non-rating revenues were assigned higher ratings.

Accordingly, there is a need to look at tackling the underlying cause of conflict of interest, related to the ‘issuer pays’ model, and the long relationships between CRAs and issuers due to lack of competition, instead of combatting specific conflicts. Different jurisdictions have attempted to address this issue.

### Comparative Perspective

#### *European Union*

In the EU, the Regulation (EC) No 1060/2009 (**‘EU Regulation’**) on Credit Rating Agencies as amended subsequently in 2011 and 2013<sup>56</sup> provides the legal framework for the regulation of CRAs. The EU Regulation recognises the conflict generated by the ‘issuer pays’ model. The European Commission has been commissioned to explore possible alternatives to the ‘issuer pays’ model.<sup>57</sup> However, no wholesale migration to an alternative model has been possible.

In addition, to combat the basic problems of ‘issuer pays’ and excessive familiarity due to lack of competition, the EU has relied on rotation mechanisms since 2009. In 2009, the EU required CRAs to establish a rotation mechanism in relation to rating analysts and persons responsible for approving credit ratings. Rotation of such persons is required to be undertaken in phases on the basis of individuals rather than of a complete team, and lead rating analysts cannot be involved in credit rating activities related to the same rated entity or a related third party for a period exceeding four years. Thereafter, a cooling off period of 2 years is mandated.<sup>58</sup>

In 2013, rotation mechanisms were introduced for CRAs themselves in respect of specific classes of particularly vulnerable transactions. Article 6b provides a maximum time limit of four years on contractual relationships between CRAs and issuers for re-securitization transactions. An exemption is provided in cases where at least 4 CRAs have each rated more than 10% of the total number of outstanding rated re-securitizations with underlying assets from the same originator.

#### *United States of America*

In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act (**“Dodd Frank Act”**) contains provisions in relation to regulation of CRAs.

S. 939 of the Dodd Frank Act requires the Securities and Exchange Commission (**“SEC”**) in the US to comment on the feasibility of a system of assignment of specific CRAs to issuers for the

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<sup>55</sup> Ramin P. Baghai and Bo Becker, *Non-rating revenue and conflicts of interest* (2016) available at [https://www.nseindia.com/research/content/1415\\_BS6.pdf](https://www.nseindia.com/research/content/1415_BS6.pdf).

<sup>56</sup> By Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011; Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011; Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013; Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014.

<sup>57</sup> Council Regulation 1060/2009 of 16 September 2009 on credit rating agencies [2009] OJ L302/1, Recital 73.

<sup>58</sup> Council Regulation 1060/2009 of 16 September 2009 on credit rating agencies [2009] OJ L302/1, art. 7.

determination the credit ratings for the products of an issuer in the first instance.<sup>59</sup> Furthermore, in case it is deemed necessary or appropriate in public interest and for protection of investors, the SEC is empowered to issue rules in this regard. In pursuance of this, the SEC suggested several mechanisms to counter conflicts of interest arising from issuer pays model. These include:

- Establishment of a CRA Board to assign CRAs to issuers of structured finance products for the determination of the credit ratings for such products in the first instance.<sup>60</sup>
- Development of a disclosure mechanism to enable non-hired CRAs to issue ratings in respect of structured finance products in the first instance.<sup>61</sup>
- Establishment of Investor Owned CRAs. Such agencies would be established by sophisticated investors. Issuers of structured finance products would be legally required to obtain two ratings- one from a CRA of their choice and another from the aforesaid entities.<sup>62</sup>
- Adoption of alternate revenue models for compensating CRAs to reduce their financial dependence on the issuers of structured finance products.<sup>63</sup>

However, no alternate revenue model has been adopted in the United States.

### Indian Position

The CRA Regulations currently recognise only the issuer-pays model for CRAs.<sup>64</sup> Regulation 14 mandates that CRAs should enter into written agreements with clients whose securities it proposes to rate regarding payment of fees, etc. However, as in other jurisdictions, it is important to explore alternatives to this revenue model.

In 2009, the Report of the Committee on Comprehensive Regulation for Credit Rating Agencies analysed the use of alternate models of payment for CRAs. These alternate models include investor pays model, the government pays model, and the exchange pays model.<sup>65</sup> However, the report identified that an investor pays model may result in higher costs of rating, and bias against smaller issuers/ borrowers. It was also recognised that the government pays model may result in moral hazard. Finally, it was recognised that the exchange pays model would not have a wide reach, although other commentators have recognised that such a model could also result in mechanistic

<sup>59</sup> Section 939F of the Dodd Frank Act.

<sup>60</sup> SEC, *Report to the Congress on Assigned Credit Ratings*, available at <https://www.sec.gov/news/studies/2012/assigned-credit-ratings-study.pdf> at 28-30.

<sup>61</sup> *Id.* at 54-55.

<sup>62</sup> *Id.* at 62, 71.

<sup>63</sup> *Id.* at 64-71.

<sup>64</sup> See Regulation 14, CRA Regulations.

<sup>65</sup> As their name suggests, the investor pays model envisages that the investors who are using the credit ratings should pay for access to ratings, the government pays model envisions that the government should choose the CRA which would rate the instrument and would pay for the rating, and the exchange pays model requires the exchange on which the security is being traded to assign a CRA as well as pay for the rating.



assignment of CRAs. Thus, it was recommended that alternative models to issuer pays may not completely replace the issuer-pays model.<sup>66</sup>

However, SEBI should practically explore the feasibility of alternatives to the issuer-pays model, for at least a few instruments, if not all. For instance, at least for securities traded on exchanges, an exchange pays model could be adopted. Here, exchanges as market institutions may be able to choose CRAs and pay them in an efficient manner. The financial burden on the exchange could be shared by the issuers in the form of higher trading fees.<sup>67</sup>

Moreover, recently, the RBI in exercise of its powers to resolve the stress of banks, announced that CRAs would play an instrumental role in this process.<sup>68</sup> To minimize conflicts of interests, RBI has been exploring methods designed to reduce conflicts of interest including feasibility of the determination of rating assignments by RBI (and not by the issuers) and payment to CRAs out of a special fund constituted by the RBI. This would mean that the issuers would neither choose which CRAs would rate their products, nor make payments to the CRA. This would fundamentally re-align the interests of the CRAs and the investors, and remove distortions. While there is no evidence as to the sustainability of such a system in the long run, SEBI could facilitate this by modifying amending their regulations to enable such a model to function. Specifically, this would require that Regulation 14 be amended to emphasise that its requirements need be followed only in the event that the issuer is paying, and equivalent requirements may be put in place with respect to other revenue models. SEBI should closely track this exercise to understand if any viable solutions exist to the issuer pays model for such debt instruments, and if yes, how can they be brought into the industry.

As of date, SEBI has laid down no specific rules and regulations to counter the problems arising out of long term relationships being developed between the CRA, its employees, or its analysts and issuers, which “*could compromise the independence of rating analysts and persons approving the ratings.*”<sup>69</sup> To regulate similar concerns arising out of long periods of engagement in cases of company auditors, the Companies Act, 2013 had included provisions requiring rotation of auditors for specific classes of companies.<sup>70</sup> Section 139 of the Companies Act, 2013 requires that auditors, whether individuals or firms, of the company cannot serve for a consecutive period of more than 10 years.

However, a similar rotation mechanism cannot be implemented wholesale in respect of CRAs. Since there are very few CRAs in the country, the rotation could be rendered mechanistic. Moreover, requiring wholesale rotation over a period of time may also make the rating activity costly, since it is cheaper to review a rating than to rate afresh.<sup>71</sup> Accordingly, an appropriate cost-benefit analysis

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<sup>66</sup> Report of the Committee on Comprehensive Regulation for Credit Rating Agencies, 2009,35-39; Jennifer Payne, ‘The Role of Gatekeepers’ in N. Moloney, E. Ferran and J. Payne (eds.), *Oxford Handbook of Financial Regulation* (OUP 2015), 266-67.

<sup>67</sup> Report of the Committee on Comprehensive Regulation for Credit Rating Agencies, 2009; 38-39.

<sup>68</sup> RBI Press Release, dated May 22, 2017, *Reserve Bank of India Outlines the action plan to implement the Banking Regulation (Amendment) Ordinance, 2017*, available at [https://www.rbi.org.in/scripts/BS\\_PressReleaseDisplay.aspx?prid=40518](https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=40518).

<sup>69</sup> Credit Rating Agencies on the Watch List: Analysis of European Regulation, Raquel García Alcubilla and Javier Ruiz del Pozo (2012), 173.

<sup>70</sup> Companies Act, 2013, sec 139.

<sup>71</sup> Recital 13, Council Regulation 462/2013 of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies [2013] OJ L146/1.



needs to be made regarding introducing such a rotation mechanism. As a first step, SEBI could consider introducing rotation mechanisms for at least employees or analysts of CRAs when they have significant interactions with the issuer which could reduce their independence. This will at least ensure that conflicts personal to a particular employee or analyst are reduced. Over time, this approach may be extended to rotation of CRAs, based on the analysis made.

The key features of such a rotation mechanism could include:

- Identifying specific classes of rating activities for which such a rotation may be necessary
- Determining the class of employees/ analysts who would require rotation
- Determining the period of rotation
- Requiring CRAs to develop an internal rotation policy in consonance with the principles embodied in regulations.

#### **Key takeaways**

- **The underlying causes of conflict of interest for rating activities is the ‘issuer pays’ model, and long-term relationships that could compromise independence.**
- **SEBI should introduce rotation of employees, analysts and CRAs in a phased manner.**
- **SEBI should enable CRAs to adopt different payment models by amending the CRA Regulations.**
- **SEBI should conduct feasibility studies for adoption of other models, such as the exchange-pays model.**

## **B. Reducing Rating Shopping**

Rating shopping occurs when an issuer solicits ratings from multiple CRAs but only pays for and discloses the highest rating(s).<sup>72</sup> Studies in the wake of the 2008 global financial crisis have noted the prevalence of this practice in the period leading up to the crisis.<sup>73</sup> One study examining the trends during this period notes that rating shopping by issuers and securitizers added to the competitive pressures on CRAs to retain clients. This led to CRAs issuing inflated ratings and deviating from their rating models in “*a competitive race to the bottom.*”<sup>74</sup>

With increase in the complexity of financial instruments, there may be greater incentives for issuers to shop for credit ratings. As a study notes:

<sup>72</sup>International Monetary Fund, Global Financial Stability Report-2009 available at <https://www.imf.org/en/Publications/GFSR/Issues/2016/12/31/Navigating-the-Financial-Challenges-Ahead> at 83.

<sup>73</sup> See for e.g., Benmelech, Effi, and Jennifer Dlugosz, *The Credit Rating Crisis*, NBER Working Paper No. 15045 available at <http://www.nber.org/papers/w15045>.

<sup>74</sup> See John Griffin and Jordan Nickerson, *Rating Shopping or Catering? An Examination of the Response to Competitive Pressure for CDO Credit Ratings* (2012) available at [https://financialreg.nd.edu/assets/153227/cdo\\_credit\\_ratings.pdf](https://financialreg.nd.edu/assets/153227/cdo_credit_ratings.pdf) at 31.

*“When assets are simple, agencies’ ratings are similar and the incentive to ratings shop is low. When assets are sufficiently complex, ratings differ enough that an incentive to shop emerges. Thus, an increase in the complexity of recently-issued securities could create a systematic bias in disclosed ratings, despite the fact that each ratings agency produces an unbiased estimate of the asset’s true quality. Increasing competition among agencies would only worsen this problem.”<sup>75</sup>*

A number of solutions have been proposed to counter the challenge of rating shopping, which include combatting the inherent conflict in the issuer-pays model, as discussed previously, establishment of rigorous disclosure norms,<sup>76</sup> and prohibiting activities that may result in rating shopping.

## **Comparative Perspective**

### ***European Union***

The EU Regulation addresses the issue of rating shopping by requiring CRAs to *avoid giving preliminary rating assessments of structured finance instruments*. This has been deemed necessary to curb the practice whereby issuers take assessments from multiple CRAs to identify those offering the best credit ratings for their instruments.<sup>77</sup>

In addition, Article 10 of the EU Regulation which pertains to the disclosure and presentation of credit ratings by CRAs, provides that CRAs should disclose credit rating ratings, rating outlooks, and information about all entities or debt instruments submitted to them for initial review or for preliminary rating. These have to be made on an ongoing basis, and have to be made even in cases issuers do not contract with a particular CRA for a final rating. However, this provision does not require CRAs to specifically identify the deals where the issuer did not hire the CRA for a final rating. Moreover, even if CRAs provided such information, it would be difficult for market participants to match a non-issued rating in a CRA’s disclosures with final ratings issued by another CRA. This is owing to the fact that fields to identify a transaction submitted for an initial review are not standardized. Furthermore, through slight variations to the structure or asset pool in the issuer’s product could be represented as being different from the one rated in an initial review.<sup>78</sup>

The EU Regulation also requires CRAs to disclose decisions to discontinue ratings in a timely manner. Furthermore, full reasons are required to be disclosed in cases when a rating is discontinued. This creates transparency in respect of decisions relating to termination of ratings contracts.

Finally, the EU Regulation require that all ratings, other than those that are investor-paid, be made accessible on a central website established by the European Securities Market Authority.<sup>79</sup> This would enable easy comparison of *all* the ratings for an issuer, and would therefore reduce the

<sup>75</sup> See Vasiliki Skreta and Laura Veldkamp, *Rating Shopping and Asset Complexity-A Theory of Ratings Inflation*, available at <http://people.stern.nyu.edu/lveldkam/pdfs/ratings.pdf>.

<sup>76</sup> Griffin et.al, *supra* note 3; Bolton et.al., *supra* note 6.

<sup>77</sup> Recital 41, Council Regulation 1060/2009 of 16 September 2009 on credit rating agencies [2009] OJ L302/1.

<sup>78</sup> Annex I, Section D, Cl. 6, Council Regulation 1060/2009 of 16 September 2009 on credit rating agencies [2009] OJ L302/1.

<sup>79</sup> Recital 31, Council Regulation 462/2013 of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies [2013] OJ L146/1.

incentives to shop since it would not be possible to disclose only a few of the ratings received. It would also give visibility to unsolicited ratings which would act as a further disincentive to rating shopping.

### ***United States of America***

In the United States, the Dodd-Frank Act intends to employ alternatives to the issuer pays model as ways to combat rating shopping. Thus, alternatives are to be explored to remove the liberty of choosing the CRA which determined the credit ratings for its financial product in the first instance from the hands of the issuer. However, as discussed previously, no legislative action in this regard has been taken.

There is also a focus on enhancing disclosures made by CRAs. Amendments were made to the General Rules and Regulations (Part 240) under the Securities Exchange Act 1934 in 2014, which require disclosures to be made when a rating action is taken by a CRA. Rating actions include *inter alia*, “publication of expected or preliminary credit rating assigned to an obligor, security, or money market instrument before the publication of an initial credit rating.”<sup>80</sup> These disclosures have to be made to the persons who can review and access the credit rating which is the subject of a rating action.<sup>81</sup>

Another mechanism was adopted in the State of New York in 2008 to counter rating shopping in case of residential mortgage backed securities. This involved an agreement between the CRAs and New York State Attorney General, requiring CRAs to adopt a fee for service revenue model while rating mortgage backed securities.<sup>82</sup> This ensured that CRAs were compensated even for their initial reviews, regardless of whether or not they were ultimately selected by issuers to issue a final rating.

### **Indian Position**

In the Indian context, rating shopping is combatted by placing restrictions on withdrawing ratings, requiring disclosures, and imposing obligations preventing unfair competition.

First, CRAs are clearly prohibited from indulging in any unfair competition or weaning away the clients of other CRAs on assurance of higher ratings, as part of the Code of Conduct.<sup>83</sup>

Secondly, CRAs are mandated to disclose their ratings even when they are not accepted by a client. This requirement is equally applicable in relation to non-public issues. The details disclosed by the CRA have to include the name of the issuer, name/ type of instrument, size of the issue, rating and

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<sup>80</sup> SEC, *Final Rules* (Adopted on August 27, 2014), available at <https://www.sec.gov/rules/final/2014/34-72936.pdf> at 661.

<sup>81</sup> *Id.*

<sup>82</sup> International Monetary Fund, *Global Financial Stability Report- (2009)* available at <https://www.imf.org/en/Publications/GFSR/Issues/2016/12/31/Navigating-the-Financial-Challenges-Ahead> at 96; Raquel García Alcubilla, Javier Ruiz del Pozo, *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (Oxford University Press 2012) 212.

<sup>83</sup> CRA Regulations, Third Schedule, Cl 16.

outlook assigned.<sup>84</sup> This reduces the incentive of the issuer to shop once a rating has actually been assigned. In addition, SEBI has introduced guidelines on making sure the disclosure of ratings is detailed and standardized, so there is greater comparability of ratings for the same products. However, despite this, there is no common platform for *all* the ratings of securities to be displayed. This still means that it is possible that the issuer may choose to highlight some favourable ratings, which could be disadvantageous to less sophisticated investors who are not fully aware. Thus, SEBI should ensure that all ratings must be displayed to reduce incentives for shopping. This may be achieved by mandating issuers to disclose all ratings in a common place on their website and offer documents, or SEBI may host all ratings on a common platform.

Finally, CRAs are required to constantly monitor, and periodically review the ratings issued by them for securities throughout the lifetime of such securities. CRAs are obligated to cause timely dissemination of information regarding newly assigned ratings or alterations in previous ratings through press releases and websites. This obligation continues even in cases of non-cooperation by the client in the rating process, on the basis of the best available information.<sup>85</sup> In fact, ratings may not be withdrawn so long as obligations in respect of the rated security are outstanding, except in limited circumstances.<sup>86</sup> This reduces the possibility of shopping for ratings, because it means that CRAs cannot withdraw ratings in cases where they recognise ratings should have been downgraded, and issuers cannot then rely on new ratings which possibly reflect a better rating. However, there seems to be an overemphasis on restricting withdrawal of ratings to curb rating shopping. In fact, onerous restrictions on withdrawal of ratings may lead to a situation when ratings issued may not be representative of the true worth of a financial instrument, since it may not be based on enough disclosures by the issuer itself. Moreover, it can only prevent shopping after the first rating is issued, but does not target shopping for the first rating itself. Indeed, in most other jurisdictions, CRAs are allowed to withdraw ratings freely as long as they disclose the reasons for withdrawal. In this light, a provision must be made in the Regulations to permit CRAs to withdraw ratings in cases of unavailability of adequate information in relation to the issuer, with the prior permission of SEBI.

Though SEBI has introduced extensive measures to combat rating shopping, the regulatory framework in India was silent in relation to interactions between CRAs and issuers prior to entering of a rating agreement between them particularly in cases when the CRAs agree to issue preliminary rating estimates. However, in July 2017, SEBI recognised that indicative ratings may be provided without entering into rating agreements, and advised CRAs *“to refrain from giving Indicative Ratings without having a written agreement in place. In case such Indicative Ratings are provided by the CRA, it shall be considered as aiding and abetting the Issuer in suppression of material information by the CRA”*.<sup>87</sup> However, this blanket banning of indicative ratings may be unduly restrictive. Instead recourse may be taken to require indicative ratings to also be given on the basis of an agreement, as a separate service. This would be separately remunerated, instead of being remunerated only if an agreement for final rating is entered into, and they would be disclosed separately which would create transparency.

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<sup>84</sup> SEBI Circular No. SEBI/HO/MIRSD/MIRSD4/CIR/P/2016/119, dated November 1, 2016, Enhanced Standards for Credit Rating Agencies (CRAs), Annex A Cl. 4.

<sup>85</sup> CRA Regulations, regs 15, 16. However, the rating symbol issued by the CRA in these cases has to indicate the fact of non-cooperation by the client in the prescribed format, and the dissemination of rating should include how the issuer has not cooperated.

<sup>86</sup> A rating might be withdrawn when a company whose securities have been rated is wound up or amalgamated with another company. However, SEBI has permitted the withdrawal of ratings in case of ratings issued for bank loans/facilities and of open ended mutual fund schemes, subject to providing notice prior to withdrawal. SEBI Circular No: SEBI/HO/MIRSD/MIRSD4/CIR/P/2017/28 dated March 31, 2017.

<sup>87</sup> SEBI Circular No SEBI/ HO/ MIRSD/ MIRSD4/CIR/P/2017/71 dated June 30, 2017.

**Key takeaways**

- There is a need to combat rating shopping activities in a balanced way.
- SEBI should consider establishing a platform to disclose all ratings given.
- SEBI should revisit grounds for withdrawal of ratings to permit withdrawal in a larger number of situations.
- SEBI should establish a framework to regulate preliminary rating estimates, instead of completely prohibiting them.

### C. Increasing accountability towards investors

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CRA's lend significant reputational capital to the debt instruments rated investment grade by them. In addition, since they act as gatekeepers and are allowed to give regulatory licenses, some investors mandatorily rely on their decisions.<sup>88</sup> Since CRA's have a “*significant impact on investment decisions*”,<sup>89</sup> they owe a responsibility to investors to ensure that their ratings are “*independent, objective and of adequate quality*”.<sup>90</sup>

Traditionally, it was believed that reputational constraints would ensure that CRA's perform their duties with diligence and independence. However, the force of reputational constraints has not been as successful as was hoped, since rating agencies can use the “*opaqueness of ratings*” as a cover for inaccuracy, or can claim that their ratings focus on the long-term view as opposed to markets which are more short-sighted.<sup>91</sup>

This has brought forth the need to ensure that CRA's are made legally responsible to investors, issuers, and the markets, much like auditors, security analysts and merchant bankers.<sup>92</sup> A credible

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<sup>88</sup> Aline Darbellay & Frank Partnoy, *Credit Rating Agencies and Regulatory Reform* (Legal Studies Research Paper, No.12-083, 2012)), 1.

<sup>89</sup> Council Regulation 462/2013 of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies [2013] OJ L146/1.

<sup>90</sup> Council Regulation 462/2013 of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies [2013] OJ L146/1.

<sup>91</sup> Jeffrey Manns, ‘Downgrading Rating Agency Reform’, *The George Washington Law Review* (2013) 81(3), 749.

<sup>92</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010. sec 933(2); Securities Exchange Act, 1934, sec 15E(m).

threat of litigation can potentially improve their performance and ensure their independence.<sup>93</sup> It may also add to the reputational risk of CRAs since litigation produces reputational damage.<sup>94</sup>

However, it has been difficult to make CRAs legally responsible to *investors*, who are most vulnerable to rely on wrongful ratings, especially since there is no contractual relationship between investors and CRAs.<sup>95</sup>

CRAs argue that *first*, their ratings are only opinions on the creditworthiness of the securities, and do not constitute an opinion to invest in a security. *Secondly*, CRAs only contract with the issuer to assign a rating. They do not contract with the investors directly, and have no proximate connection with them. Thus, they cannot foresee who will rely on the rating and the fee earned by them is not commensurate to the potential liability. In other words, this would result in imposing “*liability in an indeterminate amount, for an indeterminate time, to an indeterminate class*”<sup>96</sup> on the CRAs.<sup>97</sup> This fear is particularly potent in cases where the securities are being traded in secondary markets. *Thirdly*, this may result in a chilling effect on market activity by CRAs. CRAs would be less willing to make independent judgments on the creditworthiness of instruments.<sup>98</sup>

While ratings given by CRAs do not constitute a recommendation to invest in a security, they represent “*a thorough review of the financial condition of the issuer and the terms of his offer, based on a comprehensive analysis of facts.*”<sup>99</sup> Thus investors, at the least, rely on the facts that the ratings purport to have factored in.<sup>100</sup>

In addition, CRAs may be in a position to foresee that their ratings will be relied on by investors, especially in cases of primary issue of securities to limited parties.<sup>101</sup> In any event, where the rating is in respect of securities, many jurisdictions recognize that reliance on public statements of certain parties can be presumed.<sup>102</sup>

<sup>93</sup> Jennifer Payne, ‘The Role of Gatekeepers’ in N. Moloney, E. Ferran and J. Payne (eds.), *Oxford Handbook of Financial Regulation* (OUP 2015), 272-73.

<sup>94</sup> John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (OUP, 2006) 325.

<sup>95</sup> Matthias Lehmann, ‘Civil liability of rating agencies—an insipid sprout from Brussels’ *Capital Markets Law Journal* (2016) 11(1), 60.

<sup>96</sup> *Ultramares Corporation v. Touche* [1931] 174 N.E. 441, 444.

<sup>97</sup> Norton Rose Fulbright, ‘Civil liability of Credit Rating Agencies’ (April 2014) (<http://www.nortonrosefulbright.com/knowledge/publications/114278/civil-liability-of-credit-rating-agencies>).

<sup>98</sup> Prof. Dr. Brigitte Haar, *Civil Liability of Credit Rating Agencies after CRA 3- Regulatory All-or-Nothing Approaches Between Immunity and Over-Deterrence* (University of Oslo Faculty of Law Legal Studies Research Paper, Series No. 2013-02, 2013).

<sup>99</sup> Matthias Lehmann, ‘Civil liability of rating agencies—an insipid sprout from Brussels’, (2016) 11(1) *Capital Markets Law Journal* 60.

<sup>100</sup> Matthias Lehmann, ‘Civil liability of rating agencies—an insipid sprout from Brussels’ (2016) 11(1) *Capital Markets Law Journal* 60.

<sup>101</sup> *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65.

<sup>102</sup> David M. Brodsky and Jeff G. Hammel, ‘The Fraud on the Market Theory and Securities Fraud Claims’ 230(82) *New York Law Journal* (October, 2003), [https://www.lw.com/upload/pubContent/\\_pdf/pub835.pdf](https://www.lw.com/upload/pubContent/_pdf/pub835.pdf) .

Moreover, the possibility of a chilling effect on the activities of CRAs can be guarded against. Understandably the rating provided by any agency involves a judgment that may not always be correct, and therefore no liability should be imposed only on the grounds that the debt instrument does not perform as well as envisaged. Instead, liability should be imposed only in those cases where CRAs do not perform their duties as envisaged in the law, and do not comply with the standards of their own rating methodologies.<sup>103</sup> Indeed, this is a mechanism to ensure that CRAs comply with their basic duties while conducting all ratings, and do not hold out the inducement of more favourable ratings to receive more business.

Given this, various jurisdictions have made CRAs responsible to investors directly, and have allowed investors to sue CRAs for civil remedies. However, the scope of responsibility imposed on CRAs through such a mechanism differs considerably.

### Comparative Perspective

#### *European Union and United Kingdom*

The European Union introduced the concept of civil liability of CRAs through Article 35a in the EU Regulation in 2013. This article prescribes that the following elements will constitute a situation in which civil liability should be imposed-

- Intentional commission or gross negligence,
- Infringe the duties laid down in the Directive,
- Infringement has an impact on the credit rating issued,
- Investor reasonably relies with due care for decision to invest into or divest of the financial instrument,
- Damage to investor.

This article puts the burden of proof on the investor to show that the CRA has committed an infringement. However, the burden would have to be assessed keeping in mind that the investor would not have access to information that lies solely within the sphere of the CRA.

The article also allows member states to limit the liability of CRAs in a manner that is reasonable and proportionate.<sup>104</sup>

Following the European Directive, the United Kingdom introduced the Credit Rating Agencies (Civil Liability) Regulations, 2013. These Regulations apply the European Article 35a in the UK, adapting the obligations under the Article in accordance with UK's internal legal position.

Significantly, the United Kingdom allows an action to lie against a CRA only if there is an intentional commission of an infringement or if the infringement occurs due to gross negligence, amounting to recklessness. This means that an investor can only pursue a claim against a CRA if the management

<sup>103</sup> Matthias Lehmann, 'Civil liability of rating agencies—an insipid sprout from Brussels' (2016) 11(1) Capital Markets Law Journal 60.

<sup>104</sup> Council Regulation 462/2013 of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies [2013] OJ L146/1.



acted without caring whether an infringement occurred.<sup>105</sup> Merely showing that there was a failure to take reasonable care to prevent the commission of the infringement would not be sufficient.<sup>106</sup>

In addition, the credit rating agency may plead limitation of liability based on:

- The contractual negotiation between the investor and the credit rating agency, if any;
- The price agreed between the investor and the CRA;
- Lack of proximity between the investor and the CRA;
- Unexpected and unusual uses of the rating;
- Lack of foreseeability of the losses incurred;
- Lack of the possibility to insure against the loss;
- Lack of resources to meet such a loss.<sup>107</sup>

Thus, the Regulations incorporate the tests of foreseeability and proximity in determining the extent of liability. These are essential elements of proving negligence in tort law.<sup>108</sup> Typically, in making a determination of foreseeability for CRAs, the courts will determine if the losses could have been ‘reasonably been anticipated’.<sup>109</sup>

Since the introduction of this Regulation, no civil liability claim against CRAs has succeeded. The test for proximity is hard to establish and civil liability would be extremely difficult to enforce against CRAs.

### ***United States of America***

Traditionally, the United States provided extensive exemptions to CRAs from liability for their statements. Among other things, some courts in the United States extended First Amendment (free speech) protections to the ratings issued by CRAs.<sup>110</sup>

However, in the aftermath of the global financial crisis, the United States of America was one of the first jurisdictions to impose civil liability on CRAs. Through the enactment of the Dodd-Frank Act the United States has subjected CRAs to expert liability.<sup>111</sup>

The Dodd Frank Act amended the Securities Exchange Act, 1934 such that

- *Removal of exemption:* Exemption from liability for CRA opinions was removed as their statements were not considered forward looking statements any longer.

<sup>105</sup> Credit Rating Agencies (Civil Liability) Regulations, 2013, reg 4.

<sup>106</sup> Norton Rose Fulbright, ‘Civil liability of Credit Rating Agencies’ (April 2014) (<http://www.nortonrosefulbright.com/knowledge/publications/114278/civil-liability-of-credit-rating-agencies>).

<sup>107</sup> Credit Rating Agencies (Civil Liability) Regulations, 2013, reg 12.

<sup>108</sup> *Caparo Industries Plc v. Dickman* [1990] 2 A.C. 605.

<sup>109</sup> Winfield & Jolowicz, *Winfield and Jolowicz on Tort* (Edwin Peel and James Goudkamp eds, 19<sup>th</sup> edn, Sweetwell & Maxwell, 2014).

<sup>110</sup> Matthias Lehmann, ‘Civil liability of rating agencies—an insipid sprout from Brussels’ (2016) 11(1) *Capital Markets Law Journal* 60.

<sup>111</sup> Jeffrey Manns, ‘Downgrading rating agency reform’ (2013) 81(3) *The George Washington Law Review* 748.



- *Imposition of penal provisions:* Their statements were made subject to the same enforcement and penalty provisions as accounting firms and securities analysts. That is, if CRAs do not conduct a reasonable investigation or verification, and investors suffer loss they may be held liable.
- *Lowering pleading standard:* The pleading standard to establish the liability of CRAs was lowered, where complainants would only have to show that the facts create a strong inference that rating agencies *knowingly* or *recklessly* failed to conduct a reasonable investigation of the factual elements, that they relied on for rating, or failed to have a reasonable verification of such factual elements by independent third parties.<sup>112</sup>

Moreover, the Dodd Frank Act also enabled strict liability to be imposed on statements of CRAs in registration statements, as long as the rating was not entirely true, or omitted something. The investor is not even required to show that he relied on the statement, but simply that he bought the security after the rating was issued.<sup>113</sup>

This imposition of liability was not accepted well by the market, and CRAs refused to provide ratings in the registration statements of asset backed securities. In response, the SEC suspended the implementation of this part of the legislation.<sup>114</sup>

This indicates the importance of ensuring that civil liability is not imposed in a manner that creates a chilling effect on the activity of CRAs.

### Indian Position

Currently, if CRAs default in India, SEBI may take the following actions against the CRA:

- suspension of its certificate of registration,
- cancellation of its certificate of registration,
- prohibition on the CRA from taking a new assignment or contract for a specific period,
- prohibition on the principal officer from being associated with a CRA or any other person regulated by SEBI,
- prohibition on any branch or office of the CRA from carrying on the activity of credit rating,
- issuance of a warning to the CRA.<sup>115</sup>

Moreover, SEBI may impose penalties on CRAs for indulging in fraudulent and unfair trade practices. The penalty imposed may be between five lakh and twenty five crore rupees.<sup>116</sup> SEBI may also direct the disgorgement of unlawful gains or loss averted by CRAs.<sup>117</sup>

<sup>112</sup> Dodd-Frank Act, sec 933(2); Securities Exchange Act, 1934, sec 15E(m).

<sup>113</sup> Matthias Lehmann, 'Civil liability of rating agencies—an insipid sprout from Brussels' (2016) 11(1) Capital Markets Law Journal, 69; Dodd Frank Act, sec 939G; Securities Act, 1933, sec 11.

<sup>114</sup> Gretchen Morgenson, 'Hey, S.E.C., That Escape Hatch Is Still Open' *The New York Times* (New York, 6 March 2011) BU1.

<sup>115</sup> Securities and Exchange Board of India (Intermediaries) Regulations, 2008, reg 27 read with CRA regulations, reg 34.

<sup>116</sup> Securities and Exchange Board of India Act, 1992, sec 15HA.

<sup>117</sup> Securities and Exchange Board of India Act, 1992, sec 11B.

While SEBI has significant tools to impose litigation risk on CRAs, they have rarely taken action against defaulting CRAs in the past. However, litigation risk for negligent or fraudulent performance is little since there is little education in the market about the use of these tools to enforce responsibility on CRAs. Investors should be made aware that they can approach SEBI with information enabling it to take actions under its Regulations.

While the regulator is supposed to represent the interests of the investors, there seems to be no direct remedy for investors who rely on faulty credit ratings. SEBI has specifically emphasized the responsibility of CRAs on investors in its circulars to CRAs.<sup>118</sup> However, the lack of a direct remedy undermines the responsibility owed by CRAs to them, and also significantly reduces the litigation risk for CRAs. Since the regulator may not be in a position to intervene in all cases of misconduct, investors should be allowed to enforce the responsibility owed to them against CRAs, and claim compensation for any losses caused. This should be modelled such that an appropriate balance is struck between protecting investors and increasing litigation risk to improve performance of CRAs on one hand, and on ensuring there is no unnecessary litigation and no chilling effect on the market activity of CRAs on the other hand.

Given the specific context of Indian regulation, it may not be possible to import the models followed by other jurisdictions as is. However, in this regard, two approaches can be followed—either awareness may be generated to use existing provisions in the Companies Act, 2013 to impose liability or a new provision can be designed.

Section 35 of the Companies Act, 2013 imposes civil liability for misstatements in prospectuses. In specific, the section allows an investor to proceed against independent expert for compensation for

- a misleading statement made
- inclusion or omission of any matter in the prospectus which is misleading

if the investor has acted on it, and has sustained a loss or damage as its consequence.

Section 2(38) of the Companies Act, 2013 provides an inclusive definition of an expert which includes “*engineer, a valuer, a chartered accountant, a company secretary, a cost accountant and any other person who has the power or authority to issue a certificate in pursuance of any law for the time being in force*”. Since the expert assessment of CRAs is to be mandatorily included in a prospectus or offer document for any debt security, or before any listing of such securities, this could be considered as falling within the purview of section 35.<sup>119</sup>

However, it is less clear whether the rating by CRAs in the offer document would constitute a statement. Since the rating is not only a statement of fact, and includes a judgment, it can be argued that the rating is not a statement at all, and does not fall within the scope of this section.<sup>120</sup> However, commentators argue that a representation of belief or expectation may also constitute a representation of facts in some cases,<sup>121</sup> and thus credit ratings may constitute statements for the purposes of section 35. SEBI may thus, seek clarification from MCA regarding the application of the provision to CRAs and educate investors on the possible use of this mechanism.

<sup>118</sup> See: Securities and Exchange Board of India, Guidelines for Credit Rating Agencies, CIR/MIRSD/CRA/6/2010.

<sup>119</sup> Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008, reg 4, 20.

<sup>120</sup> Companies Act, 2013, sec 35, 36.

<sup>121</sup> A. Ramaiya, *A Guide to the Companies Act*, (18<sup>th</sup>edn, 2015).

This would impose strict liability on CRAs, and are likely to create a chilling effect on their market activities. This is especially true in their case, since their statement is not pure fact, but involves some subjective judgment as well. Thus, imposing a strict liability on CRAs in this manner, may not be the ideal way to improve the ability of investors to get after CRAs.

SEBI may thus instead consider creating a new provision to allow investors to claim compensation from CRAs directly. This would be more broad-based than the Companies Act, 2013 provisions since all kinds of investors, not merely investors in public issues, could use this mechanism. For instance, banks who rely on bank loan ratings could use this mechanism to receive compensation as well. Moreover, this will enable flexibility in order to achieve a greater balance. Keeping with SEBI's model of regulation, this may not be in the nature of a remedy enforceable in a civil court. Currently, CRAs as intermediaries have a general obligation to redress the grievances of investors.<sup>122</sup> However, there is no specific requirement to have a grievance redressal mechanism requiring them to compensate investors who have relied on negligent or fraudulent ratings. SEBI may consider making this specifically applicable to CRAs.

In addition, in prescribing what actions may be taken against CRAs for contravention of the Act, Rules and Regulations, SEBI may consider incorporating provisions on payment of compensation to aggrieved investors.

The key features of such a mechanism could include:

- *Identification of Contraventions:* Specific contraventions of duties should be identified that could lead to payment of compensation. These should be connected to the activity of rating itself, so that significant compensatory liabilities need not be imposed for contravention of any provision.
- *Identification of State of Mind:* There should be clarity on whether the CRA should have committed the contravention with intent, or if negligence is enough. Establishing intent in such cases would be extremely hard and would not be a sufficient check on the wrongful activities of CRAs.
- *Identification of the Burden of Proof:* There should be clarity on what burden investors would have to meet to show the contravention. This should be designed such that investors do not have to produce material they cannot have access to, but should still adequately protect CRAs. This could also be linked to the power of SEBI to investigate.
- *Identification of the conditions for the investors:* There should be some clarity on what conditions investors would have to meet to be able to claim compensation. For instance, the investor should have suffered a loss caused due to the reliance on rating.
- *Identification of the limits on liability of CRAs:* The amount of compensation that CRAs would have to pay in event of contravention should be limited in accordance with the foreseeability of damage, etc.

Such a mechanism would increase accountability of CRAs and improve their functioning. Moreover, if tailored narrowly, it would not have a chilling effect on the activities of CRAs.

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<sup>122</sup> Securities and Exchange Board of India (Intermediaries) Regulations, 2008, reg 13.

**Key Takeaways**

- CRAs should be held accountable to investors that use their ratings. Reputational risk has been insufficient to promote accountability, and credible litigation risk would help in such promotion.
- SEBI should encourage investors to provide them information on the basis of which they can investigate into any irregularities in the functioning of CRAs and take action where appropriate.
- SEBI should incorporate a provision to make CRAs liable for compensating investors for any loss caused to them by negligent or fraudulent rating, with adequate safeguards.

## D. Regulating Rating Activities other than Rating of Securities & Reducing Mechanistic Reliance on Ratings

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As is evidenced by its Regulations, SEBI originally intended to regulate only those rating activities of CRAs that are directly related to the securities market. However, in recent years, CRAs rate a wide variety of instruments and entities, directly related to the financial sector. The differences in instruments, therefore, needs to be accounted for while making regulations for CRAs. This is especially true since reliance on rating activities of other instruments is often mandated by regulators such as RBI. A lack of regulation of such ratings could have adverse effects, since various investors have to rely on these ratings. This, therefore, raises concern on the regulation of these activities, and the reliance on credit ratings in situations that are inadequately regulated.

A separate concern that arises is even when rating activities are adequately regulated, if reliance is mandated on them without allowing for alternative evaluation of credit risk, mechanistic reliance on these ratings is promoted. CRAs themselves state that ratings are opinions and not recommendations to buy debt instruments. Investment decisions are not meant to be based primarily on these ratings.<sup>123</sup>

Given this, it becomes necessary to examine how rating activities of CRAs pertaining to instruments other than securities should be regulated, and how mechanistic reliance on credit ratings must be reduced.

### International Practice

#### *Europe*

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<sup>123</sup> Frank Partnoy, 'Siskel and Elbert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies', *Washington University Law Quarterly*, (1999) 77(3), 619.

The European Securities and Markets Authority is the “*single direct supervisor*” of CRAs within the European Union.<sup>124</sup> ESMA supervises the rating activities of CRAs that are to be publicly disclosed -

- Rating of an entity,
- Rating of a debt or financial obligation,
- Rating of a debt security,
- Rating of a preferred share or other financial instrument,
- Rating of an issuer of the abovementioned.<sup>125</sup>

ESMA provides detailed guidance on these rating activities, which often differs according to what is being rated. To illustrate, ESMA provides very detailed standards for rating of structured finance products. They also require disclosure of rating methodologies, as well as ratings of different types of products differently.<sup>126</sup> They also specify different periodicities for review based on different types of ratings.<sup>127</sup> Thus, at least to some extent, ESMA takes into account specific considerations for rating different products.

Finally, the need to tailor regulation of rating activities specific to different classes of assets increases when CRAs are granted a regulatory license for those activities as well. To reduce mechanistic reliance on CRA ratings, the EU suggests that standard setters and authorities remove references to CRA ratings, where alternative means of credit risk assessment have been identified and implemented.<sup>128</sup>

### ***United States of America***

The SEC understands the need to have different standards of rating for different products and, grants registration to CRAs for five types of rating classes, which are

- financial institutions,
- insurance companies,
- corporate issuers,
- asset-backed securities, and
- government securities.<sup>129</sup>

Thus, CRAs need to be registered to rate all these separately.

The United States also places great emphasis on reducing reliance on credit ratings. Section 939A of the Dodd Frank Act unequivocally requires the “*total elimination of the credit ratings from*

<sup>124</sup> European Securities and Markets Authorities, ‘Credit Rating Agencies’ <<https://www.esma.europa.eu/supervision/credit-rating-agencies/supervision>><https://www.esma.europa.eu/supervision/credit-rating-agencies/supervision> ..

<sup>125</sup> Council Regulation 1060/2009 of 16 September 2009 on credit rating agencies [2009] OJ L302/1, art 2,3.

<sup>126</sup> Raquel García Alcubilla & Javier Ruiz del Pozo, *Credit Rating Agencies on the Watch List: Analysis of European Regulation*, (OUP 2012), 196-197.

<sup>127</sup> Council Regulation 1060/2009 of 16 September 2009 on credit rating agencies [2009] OJ L302/1, art 8.

<sup>128</sup> Council Regulation 462/2013 of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies [2013] OJ L146/1.

<sup>129</sup> Securities and Exchange Commission, ‘Investor Bulletin: The ABCs of Credit Ratings’ ([https://www.sec.gov/investor/alerts/ib\\_creditratings.pdf](https://www.sec.gov/investor/alerts/ib_creditratings.pdf)) .

*regulations and legislative frameworks.”*<sup>130</sup> In practice, regulators have not completely removed credit ratings, but have encouraged the use of other credit assessment metrics and mechanisms to ensure that credit ratings lose the primacy they have been accorded in the financial markets.<sup>131</sup>

## India

The CRA Regulations, primarily through which SEBI regulates CRAs, define a CRA as “*a body corporate which is engaged in, or proposes to be engaged in, the business of rating of securities offered by way of public or rights issue.*” (emphasis supplied) These Regulations also define rating as “*an opinion regarding securities, expressed in the form of standard symbols or in any other standardised manner, assigned by a credit rating agency and used by the issuer of such securities, to comply with a requirement specified by these regulations.*” (emphasis supplied)

Understanding the relevance of rating of other securities, instruments and loans or facilities provided by banks that are not regulated by SEBI, SEBI issued a circular in 2012 stating that for such ratings, “*CRAs shall follow the applicable requirements pertaining to rating process and methodology and its records, transparency and disclosures, avoidance of conflict of interest, code of conduct, etc, as prescribed in the Regulations and circulars issued by SEBI from time to time.*”<sup>132</sup>

In other words, SEBI made the regulations and guidelines applicable to credit rating of securities, applicable to instruments other than securities as is, with no modifications.

The validity of taking such an action through a circular is suspect. The circular is issued under Regulation 20 of the Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 and Section 11(1) of the Securities and Exchange Board of India Act, 1992. The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 allow SEBI to issue circulars, which Credit Rating Agencies should comply with. The scope of the Regulations cannot be expanded by a circular issued thereunder. Moreover, the power of SEBI to “*promote the development of, and to regulate the securities market, by such measures it deems fit*” under Securities and Exchange Board of India Act, 1992 may not be used by SEBI to extend the scope of its regulation to non-securities instruments.

However, there is no doubt that SEBI has jurisdiction to regulate all entities that are CRAs, by virtue of section 11 of the SEBI Act, which empowers SEBI to register, and regulate “*the working of the depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries as the Board may, by notification, specify in this behalf.*”

It is desirable that a single authority regulates CRAs. Multiple regulatory regimes should be avoided to reduce the possibility of regulatory arbitrage. Given this, SEBI should consider amending the CRA Regulations to define rating activities more broadly. This will give SEBI a better legal basis to regulate other rating activities of CRAs. Further, presently there is largely a single standard of regulation for all instruments. Therefore, SEBI should also make an assessment of how rating of other instruments or entities should be formally regulated- particularly, if different standards are required in respect of assessment metrics, disclosure and accountability. This could manifest itself

<sup>130</sup> Francesco De Pascalis, ‘Reducing regulatory reliance on credit ratings to address investors’ over-reliance: some thoughts in light of the US experience’, *Capital Markets Law Journal* (2016) 11(4), 510.

<sup>131</sup> *Id.*

<sup>132</sup> Securities and Exchange Board of India, Guidelines for Credit Rating Agencies, CIR/MIRSD/3/2012.

in requiring different registrations for different rating activities, and by requiring compliance with different substantive regulations.

In addition, other regulators must also make an attempt to reduce mechanistic reliance on CRAs, such that decisions are not required to be based primarily on ratings, irrespective of other considerations which may be specific to each investor. Mandating reliance on credit ratings by regulators could substantially increase the impact of inaccurate ratings on the system. This gets exacerbated when this reliance is placed on ratings that are not fully regulated. However, even if credit ratings are adequately regulated, the problem of mechanistic reliance might continue to exist. Therefore, other regulators must try to reduce reliance on credit ratings even if such ratings are sufficiently regulated. This can possibly be resolved by allowing investors to make a comprehensive review of all forms of credit risk assessment, including internal risk assessment mechanisms.<sup>133</sup>

#### **Key takeaways**

- **SEBI should regulate all rating activities of CRAs relating to the financial system.**
- **SEBI should amend the CRA Regulations to cover ratings other than rating of securities, to create a sound legal basis for their regulation, instead of relying merely on the circular.**
- **The CRA regulations and directions issued by SEBI should address the special concerns that arise for different instruments and entities.**
- **Regulators should only extend reliance on ratings where they are adequately regulated, and in no event, should they extend mechanistic reliance on credit ratings.**

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<sup>133</sup> See: Joint Committee of the European Supervisory Authorities, *Final Report Good Supervisory Practices for Reducing Mechanistic Reliance on Credit Ratings* JC 2016 71 (2016).

## V. CONCLUSION AND KEY RECOMMENDATIONS

While CRAs are extremely important institutions for financial markets, systemic challenges exist in their regulation. Regulators in various jurisdictions are grappling with these challenges, and are attempting to develop robust regulatory solutions.

In India, SEBI has a comprehensive regime for the regulation of CRAs. However, certain concerns relating to

- conflict of interest,
- rating shopping,
- lack of accountability to investors,
- regulation of ratings for instruments other than securities, and
- reducing mechanistic reliance on ratings

continue to persist.

Accordingly, we make the following recommendations:

Concern	Recommendations
<b>Removing conflicts of interest</b>	<ul style="list-style-type: none"> <li>• The underlying causes of conflict of interest for rating activities is the 'issuer pays' model, and long-term relationships that could compromise independence.</li> <li>• SEBI should introduce rotation of employees, analysts and CRAs in a phased manner.</li> <li>• SEBI should enable CRAs to adopt different payment models by amending the CRA Regulations.</li> <li>• SEBI should conduct feasibility studies for adoption of other models, such as the exchange-pays model.</li> </ul>
<b>Reducing Rating Shopping</b>	<ul style="list-style-type: none"> <li>• There is a need to combat rating shopping activities in a balanced way.</li> <li>• SEBI should consider establishing a platform to disclose all ratings given.</li> <li>• SEBI should revisit grounds for withdrawal of ratings to permit withdrawal in a larger number of situations.</li> <li>• SEBI should establish a framework to regulate preliminary rating estimates, instead of completely prohibiting them.</li> </ul>



<p><b>Making CRAs accountable to investors</b></p>	<ul style="list-style-type: none"> <li>• CRAs should be held accountable to investors that use their ratings. Reputational risk has been insufficient to promote accountability, and credible litigation risk would help in such promotion.</li> <li>• SEBI should encourage investors to provide them information on the basis of which they can investigate into any irregularities in the functioning of CRAs and take action where appropriate.</li> <li>• SEBI should incorporate a provision to make CRAs liable for compensating investors for any loss caused to them by negligent or fraudulent rating, with adequate safeguards.</li> </ul>
<p><b>Regulating rating activities other than rating of securities and reducing mechanistic reliance on credit ratings</b></p>	<ul style="list-style-type: none"> <li>• SEBI should regulate all rating activities of CRAs relating to the financial system.</li> <li>• SEBI should amend the CRA Regulations to cover ratings other than rating of securities, to create a sound legal basis for their regulation, instead of relying merely on the circular.</li> <li>• The CRA regulations and directions issued by SEBI should address the special concerns that arise for different instruments and entities.</li> <li>• Regulators should only extend reliance on ratings where they are adequately regulated, and in no event, should they extend mechanistic reliance on credit ratings.</li> </ul>



# Vidhi

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