Introduction and Suggestions on the Chinese Securities Credit Rating System from a Comparative Perspective

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Credit rating is a burgeoning industry in China. However, ever since it was established by State Council in 1993, the development of the industry in China has faced various impediments. There are currently three major problems hindering its further development, as result of a lack of systematic statutory and judicial guidelines. These problems are: limited competition in the industry, rampant rating shopping and conflicts of interest, and limited remedy at law in a suit against a credit rating agency for issuing false ratings.

The credit rating industry in the U.S. is dealing with the same problems. However, after the Securities and Exchange Commission (SEC) was granted statutory oversight authority by Credit Rating Agency Reform Act of 2006, the situation greatly improved. By setting forth a clear definition and qualitative requirements for Nationally Recognized Statistical Rating Organizations (NRSROs), the SEC allowed more rating agencies to participate in the market, promoting competition. This combined with SEC's prohibition on conduct by NRSROs that may involve conflicts of interest has curbed rating shopping to a substantial extent. At the same time, the economic crisis and current trends may suggest that rating

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[+] We would like to thank Professor Onnig Dombalagian and Professor Adam Feibelman for reading an earlier draft of this paper and for their invaluable comments. All errors are our own.

agencies' strongest defense in lawsuits against false ratings—the First Amendment defense—may be less effective now than before.

The rating industry in China followed a different pattern. The statutory threshold requirement proves too demanding for most rating agencies to comply with, therefore barring many potential market participants from competing. In addition, provisions prohibiting rating shopping and conflicts of interest are narrowly drawn, targeting only direct conflicts of interest. As for the issue of limited remedy for harms caused by false ratings, while freedom of speech is not a valid defense that credit rating agencies can raise in Chinese courts, judges' reluctance to recognize intangible harm, even when substantial, combined with an insufficient judicial framework overall, make it hard for plaintiffs who have suffered from such misbehavior to prevail in lawsuits against false ratings.

I. INTRODUCTION

To assist in its accession to the World Trade Organization (WTO) on November 10, 2001, China has begun to reform inefficient management systems established in the Planned Economy era.[1] These inefficient systems survived the 1978 introduction of a competitive market economy.[2] Some corporations, such as Haier Group and Lenovo Group Limited, which were formed before China's WTO accession, survived and grew into multinational corporate behemoths. With the incredible development velocity of China's capital market and the improved profitability of its domestic corporations, China has become an investment magnet, especially under the effects of the current global economic depression.[3] All these changes attract both domestic and overseas investors to purchase stocks and bonds issued or traded in China. Additionally, with the legalization of trading on financial derivatives, such as Stock Index Futures, the Chinese capital market is growing exponentially both in terms of profitability and potential risks.

Credit rating—the groundbreaking American invention of the early twentieth century—has been widely adopted as a major financial device for evaluating such risks and benefits.[4] To advance the goal of establishing itself as a world-class financial center, China must develop a

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[1] Arnaldo M. Gonçalves, *China's Swing from a Planned Soviet-Type Economy to an Ingenious Socialist Market Economy: An Account of 50 Years* 24, 36 (Centro Argentino de Estudios Internacionales, Programa de Asia-Pacífico, Paper No. 019, 2006), *available at* http://ssrn.com/abstract=949371. "Planned economy" is an economic system in which the government controls the economy. In its most extensive form it is referred to as a "command economy" or a "centrally planned economy." In China, the State Council decided what and how much of each item should be produced. Under such a system, "resource prices are in many cases distorted, failing to reflect real value, as many types of resources are still priced by the state, operating on the inertia of the old planned economy." *Id.* at 31.

[2] *See* Randall Peerenboom, Resistance, Revision and Retrenchment in the Transition to a Competitive Market Economy in China 1, 2 (La Trobe Univ. Sch. of Law, Legal Studies Working Paper Series, Paper No. 2008/8, 2008) (describing China's incremental transition to a market economy and noting that China has carved its own path and "never blindly followed the principles of the Washington Consensus[.]"), *available at* http://ssrn.com/abstract=1265114.

[3] In 2006, the Chinese State Council endorsed the construction of the World Financial Center in Shanghai, scheduled to be completed in 2020. Detailed information on this plan, as well as other construction and investment projects sponsored by the city and national governments, is *available at* http://sh.eastday.com/jrhy/index.html (last visited Apr. 15, 2010).

[4] *See, e.g.*, Edward I. Altman & Anthony Saunders, *The Role of Credit Ratings in Bank Capital*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 99–116 (Richard M. Levich et al. eds., 2002) (evaluating the use of "traditional" agency ratings in the the Basel II reforms). For an account of the rise of bond ratings in the twentieth-century U.S. and their effects on capital markets, see also Richard Sylla, *An Historical Primer on the Business of Credit Rating*, *in id.* 19–40.

sound securities credit rating system for investors and financial institutions. Such a securities credit rating system will lower the investigatory costs for the security-issuing companies, thereby resulting in significant capital savings.[5] The primary function of rating agencies includes providing professional information by assessing the creditworthiness of companies and their debt obligations.[6] Ratcheting up the credibility and improving the performance of credit rating agencies are now the first priorities on the Chinese financial reform agenda.[7]

Part II of this Essay provides a basic summary of the current situation of the Chinese credit rating system. Part III discusses some of the difficulties that Chinese credit rating agencies face in improving creditability, with a focus on systemic problems in market development and possible legal remedies. Part IV analyzes the history and development of U.S. credit rating regulation and effects of recently introduced rating agency reforms on the regulatory framework, with a particular focus on post-Enron reforms. Part V extensively analyzes major U.S. credit rating reforms, focusing on the problems that puzzle Chinese observers: competition, conflict of interest and accountability of rating agencies. Although the legal framework for U.S. credit rating is still undergoing significant changes, it provides the Chinese legislature and practitioners with important lessons and theoretical foundations. Part VI provides a prescription for Chinese credit rating legislation and insights on credit rating adjudication, which can facilitate private enforcement and indirectly improve the credibility of rating agencies in China.

II. THE CURRENT SECURITIES CREDIT RATING SYSTEM IN CHINA

The current Chinese securities credit rating system was established in 1993 by the State Council.[8] The Council originally

[5] *See* Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. SUPP. 341, 342 (2006) (explaining rating agencies' unique ability to assess credit worthiness and "facilitate the raising of capital by providing information to investors at a lower cost").

[6] *Id.* For a description of the role of credit rating agencies in evaluating issuers and the importance of credit ratings to investors, see SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS: AS REQUIRED BY SECTION 702(B) OF THE SARBANES-OXLEY ACT OF 2002, at 25–29 (Jan. 2003) [hereinafter SEC Report], *available at* www.sec.gov/news/studies/credratingreport0103.pdf.

[7] *See* He Minhua [何敏华], *Duanqi Rongzi Quan Xinyong Pingji Guongzuo Cunzai de Jige Wenti* [短期融资券信用评级工作存在的几个问题] [*Some Remaining Issues in the Work of Credit Rating Short-term Financing Securities*], 14 ZHONGGUO JINRONG [中国金融] [CHINA FINANCE] 56, 57 (2007) (discussing major problems still affecting Chinese credit rating agencies).

[8] *See* Wang Zhaohui [王昭慧] & Dong Fenyi [董奋义], *Dui Woguo Xinyong Pingji Jigou*

regulated the issuance of corporate bonds valued over 100 million RMB.[9] In 2004, after several years of ill-reception by the market and confusion of the credit rating system, the State Council issued guidelines on reforming the capital markets.[10] This triggered a nationwide adoption and application of the credit rating system.[11] Several regulations were enacted by the State Council and its administrative agencies according to the authorization of the Securities Law.[12]

China's Securities Law, Article 169(2) provides that:

> "[t]he measures for the administration of examination and approval of the practice of securities trading services by investment consulting institutions, financial advising institutions, credit rating institutions, asset appraisal institutions and accounting firms shall be formulated by the securities regulatory authority under the State Council and the relevant administrative departments."[13]

Cunzai Wenti de Tantao [对我国信用评级机构存在问题的探讨] [*Discussion on Current Problems of Chinese Credit Rating Agencies*], 500 SHANGCHANG XIANDAIHUA [商场现代化] [MARKET MODERNIZATION], 2007 no. 4, Apr. 2007, at 63–65 (2007) (discussing the historical development and problems of the Chinese credit rating system).

[9] *Id.*

[10] Guowuyuan Guanyu Tuijin Ziben Shichang Gaige Kaifang he Wending Fazhan de Ruogan Yijian [国务院关于推进资本市场改革开放和稳定发展的若干意见] [Some Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets] (promulgated by the St. Council, Jan. 31, 2004, effective Jan. 31, 2004) (P.R.C.), *available at* http://www.gov.cn/gongbao/content/2004/content_63148.htm (last visited Apr. 15, 2010).

[11] *See* Wang & Dong *supra* note 8.

[12] To date, these regulations include: Zhengquan Shichang Zixin Pingji Yewu Guanli Zanxing Banfa [证券市场资信评级业务管理暂行办法] [Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market] [hereinafter Interim Measures] (promulgated by the China Sec. Regulatory Comm'n, Aug. 24, 2007, effective Sep. 1, 2007) (P.R.C.); Zixin Pingji Jigou Chuju Zhengquan Gongsi Zhaiquan Xinyong Pingji Baogao Zhunze [资信评级机构出具证券公司债券信用评级报告准则] [Guidelines for Issuing Credit Reports for the Bonds of Securities Companies by Credit Rating Agencies] (promulgated by the China Sec. Regulatory Comm'n, Aug. 29, 2003, effective Oct. 8, 2003), http://www.winaaa.com/policy/info/200412257390.shtml (P.R.C.); Qiye Zhaiquan Guanli Tiaoli [企业债券管理条例] [Interim Regulations on Administration of Enterprise Bonds] (promulgated by the St. Council, Mar. 27, 1987, effective Mar. 27, 1987) (P.R.C.).

[13] *See* Zhonghua Renmin Gongheguo Zhengquan Fa [中华人民共和国证券法] [Securities Law of the People's Republic of China] (2005) [hereinafter 2005 Securities Law], art. 169 (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) (P.R.C.).

The State Council authorized the China Securities Regulatory Commission (CSRC), an administrative agency, to supervise and regulate the credit rating agencies. All securities credit rating agencies in China are subject to the authority of CSRC. According to the Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market (Interim Measures), which was enacted by CSRC in 2007, incorporating securities credit rating agencies shall be approved and designated by CSRC first.[14] There are some other regulations promulgated by the State Council relating to the securities credit rating agencies and credit rating businesses, such as the Guidelines for Issuing Credit Reports by Credit Rating Agencies for the Bonds of Securities Companies and Company Bonds Control Regulation.[15] However, these regulations and guidelines are incomplete and usually have only one or two provisions substantively related to credit rating, while the rest are mostly boilerplate.[16] Therefore, in practice, the Interim Measures are the core regulation which applies to the securities credit rating agencies. Additionally, both securities law and the Interim Measures incorporate into their provisions fiduciary duty and duty of care, which are common law inventions.[17] Although the statements in these laws are rather generalized, they constitute the sources of legal authority for private parties as to when the credit rating agencies breach their fiduciary duties.

These regulations lay out the threshold criteria for institutions wishing to submit application to CSRC in order to be accredited as credit ratings agencies. Some of these threshold criteria have been regarded as hurdles which discourage necessary competition in the Chinese securities credit rating market. At the end of 2008, there were only five designated securities credit rating agencies,[18] all of which derived their designations

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[14] *See* Interim Measures, *supra* note 12, at art. 2 (constituting the securities credit agency regulation of the People's Republic of China).

[15] *See* Guidelines for Issuing Credit Reports for the Bonds of Securities Companies by Credit Rating Agencies, *supra* note 12.

[16] *See* Shi Fang [施放] et al., *Woguo Xinyong Pingjiye Fazhan Xianzhuang ji Wenti Yanjiu* [我国信用评级业发展现状及问题研究] [*The Issues and Development Status of China's Credit Rating System*], 491 SHANGCHANG XIANDAIHUA [商场现代化] [MARKET MODERNIZATION] 396 (Jan. 2007) (discussing the meager and incomplete effect of regulation on credit rating).

[17] *See* 2005 Securities Law, *supra* note 13, at art. 152; Interim Measures, *supra* note 12, at art. 36.

[18] The five agencies as of December 31, 2008 were: Zhong Cheng Xin Securities Credit Rating Co. Ltd.; Shanghai New Century Credit Rating & Investment Services Co. Ltd.; Peng Yuan Credit Rating Co. Ltd.; Da Gong International Credit Rating Co. Ltd.; and Tianjin Zhong Cheng Credit Rating Co. Ltd. *See* China Sec. Regulatory Comm'n, *Congshi Zhengquan Shichang Zixin Pingji Yewu de Zixin Pingji Jigou Mingdan (Jiezhi 2008 Nian 12 Yue 31 Ri* [*List of Approved Securities Credit Rating Institutions (as of Dec. 31, 2008)*], *available at* http://www.csrc.gov.cn/pub/zjhpublic/G00306205/200804/t20080430_23237.htm (last visited Apr. 16, 2010) (P.R.C.).

in 1990 when the CSRC began designating securities credit rating agencies.[19] Subsequently, no new agencies have received designation.

III. PREDICAMENTS OF THE CURRENT SYSTEM IN CHINA

It is hardly news that the burgeoning Chinese capital market is drawing global attention while foreign direct investment has continued to grow in the double digits. Meanwhile, the State Council in 2010 emphasized that China intended to continue attracting more international capital into its domestic capital market.[20] A huge market demand for reliable ratings therefore still awaits the emergence of a mature domestic securities credit rating business. However, current securities credit rating regulation is hardly keeping abreast with market developments. Many scholars believe that the regulatory framework is far from satisfactory and that a more substantive securities credit rating reform is imperative.[21] Generally, there are three major problems within the current securities

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[19] The five agencies have maintained their advantage ever since they were included on the first approval list issued by the State Council, although some later changed their name. *See* People's Bank of China, *Guanyu Zhongguo Chengxin Zhengquan Pinggu Youxian Gongsi deng Jigou Congshi Qiye Zhaiquan Xinyong Pingji Yewu Zige de Tongzhi* [关于中国诚信证券评估有限公司等机构从事企业债券信用评级业资格的通知] [*Notice Regarding Professional Qualification to Rate Enterprise Bonds of China Chengxin Securities Credit Rating Co. Ltd. and Other Organizations*] (issued by the People's Bank of China, Dec. 16, 1997), http://www.pbc.gov.cn/publish/tiaofasi/584/1404/14045/14045_.html.

[20] *See* China Sec. Regulatory Comm'n, Guowuyuan Guanyu Jinyibu Zuohao Liyong Wai Zi Gongzuo de Ruogan Yijian [国务院关于进一步 做好利用外资工作的若干意见] [State Council Opinion on Further Advancing the Use of Foreign Capital] (promulgated by the St. Council on Apr. 6, 2010), http://www.gov.cn/zwgk/2010-04/13/content_1579732.htm (P.R.C.) (discussing the policy on foreign investment and encouraging more foreign capital investment). In 2012, for the first time in a number of years, China surpassed the U.S. as the world's leading recipient of foreign direct investment. Jack Perkowski, *China Leads in Foreign Direct Investment*, FORBES.COM, Nov. 5, 2012, http://www.forbes.com/sites/jackperkowski/2012/11/05/china-leads-in-foreign-direct-investment.

[21] *See, e.g.*, He Minhua, *supra* note 7, at 56; Gao Han [高汉], *Jinrong Weiji Beijing Xia de Xinyong Pingji Jigou Jianguan Wenti Fenxi—yi Meiguo Xinyong Pingji Jigou Jianguan wei Shijiao* (金融危机背景下的信用评级机构监管问题分析—以美国信用评级机构监管为视角) [*Analysis of the Regulation of Credit Rating Agencies in the Current Financial Crisis—Using the Regulation of American Credit Rating Agencies as a Comparison*], 36.6 HENAN SHIFAN DAXUE XUEB [河南示范大学学报（哲学社会科学版）] [J. OF HENAN NORMAL UNIV. (PHILOSOPHY & SOC. SCI. EDITION] 151 (Nov. 2009); Liu Yongming [柳永明], *Meiguo dui Xinyong Pingji Jigou de Jianguan: Zhenglun yu Qishi* [美国对信用评级机构的监管：争论与启示] [*Inspiration from the U.S. Regulation of Credit Rating Agencies: Debate and Enlightenment*], 12 SHANGHAI JINRONG [上海金融] [SHANGHAI FIN.] 57 (2007).

credit rating system: limited competition, rating shopping, and limited remedy for harms suffered as a consequence of false ratings.

A. Limited Competition

Credibility is crucial for credit rating agencies. Through the accreditation process, a state licensing institution provides a credit rating agency with such credibility in the market. In China's credit rating market, private investors regard administrative agency licensing as highly reliable. As mentioned above, any agency performing credit rating must first acquire CSRC accreditation status.[22] Article 226(2) of the Securities Law stipulates that:

> "[w]here an investment consulting institution, financial advising institution, credit rating institution, asset appraisal institution or accounting firm undertakes any securities trading service without [having first acquired] the relevant approval[s], it shall be ordered to correct [the situation]. The illegal proceeds [earned in the intervening period] shall be confiscated, and a fine from 1 to 5 times the illegal proceeds shall be imposed upon it."[23]

This mechanism is similar to that of the United States. In 1973 the Securities and Exchange Commission (SEC) issued Rule 15c3-1,[24] which incorporated ratings from any Nationally Recognized Statistical Rating Organization (NRSRO). This accreditation signals to the market that certain credit rating firms deserve a greater degree of confidence. Only ten agencies have received the NRSRO status to date.[25] But, while being designated by the SEC as an NRSRO is an elective procedure and simply benefits credit rating agencies by further guaranteeing their dominant status in the U.S. credit rating business,[26] in China the CSRC licensing is mandatory. This CSRC restriction has heightened the economic costs of competition. The consequent lack of market competition over the past

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[22] *See* Interim Measures, *supra* note 12 (stipulating that "[t]o engage in the [securities rating business], a credit rating agency shall, according to these Measures, apply to China Securities Regulatory Commission [(the "CSRC")] to be licensed for the securities rating business," and adding that "[w]ithout licensing by the CSCRC . . . , no entity or individual may engage in the securities rating business.").
[23] *See* 2005 Securities Law, *supra* note 13, at art. 226.
[24] 17 C.F.R. § 240.15c3-1 (imposing net capital requirements for brokers and dealers in an SEC rule which incorporates ratings by NRSROs).
[25] *See* Arthur R. Pinto, *supra* note 5, at 348–49.
[26] *See, e.g.*, Frank Partnoy, *The Siskel and Ebert of Financial Markets: Two Thumbs down for the Credit Rating Agencies*, 77 WASH U. L.Q. 619 (1999).

twenty years has allowed the five licensed agencies to dominate and divide the market geographically, and to form exclusive connections with big-profile clients. Some of these clients are nationally-operated state-owned enterprises (SOEs). As a result, the operation of credit ratings in China is far from transparent. What's more dangerous is that the agencies are upsettingly slow to the market. These problems may be reminiscent of those that existed in the American credit rating industry before the Enron scandal.[27]

B. Rating Shopping

In addition to the problem of limited competition, the Chinese credit rating market suffers from excessive rating shopping. Rating shopping occurs when rated institutions cherry-pick agencies that will provide them with better ratings. This practice undermines the credibility of ratings, and poses hazards to the macro credit rating market. Rating shopping arises from the moral hazard involved when rating agencies attempt to please clients issuing securities, rather than serving investors.

Currently, there is no consensus as to the causes of rating shopping in the Chinese market. While some U.S. scholars believe that intense competition among rating agencies leads to rating shopping,[28] some Chinese scholars argue that rating shopping would have happened in the Chinese market even with limited competition.[29]

Better and more credible securities credit rating should facilitate security issuance and lower the cost of capital.[30] The act of rating shopping adversely affects the credibility and accuracy of credit ratings. In practice, credit agencies face great pressure from clients, for whom ratings determine the cost of credit. Thus, Chinese agencies consolidate their existing market share by offering clients better ratings.[31] If the agencies prioritize professional integrity, they face a potential boycott from securities issuers.[32] This leads to rating inflation. Because no credit rating agency wants to lose the battle over market share, rating inflation has become rampant over the past 10 years. Such rating inflation confuses investors and erodes the credibility and accuracy of credit ratings.

C. Limited Remedy in Suits Against False Ratings

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[27] *See* Arthur R. Pinto, *supra* note 5, at 349.

[28] Some United States scholars are opposed to lifting the NRSRO bar because they think competition will cause rating shopping. *See, e.g.*, JOHN C. COFFEE, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 299–300 (2006).

[29] *See* He Minhua, *supra* note 7, at 57.

[30] *Id.*

[31] *Id.*

[32] *Id.*

Potential *ex post* liability through private enforcement is a means to control misbehavior by credit rating agencies. In China, however, such means are rather limited. In the United States, an issuer may bring suit on a claim of defamation for false or faulty ratings, while investors who act in reliance on such ratings might allege the tort of negligent misrepresentation and breach of the agency's duty of care.[33] Although in China private parties can bring suit for defamation caused by an uncontracted agency's retaliatory rating, the damage resulting from such defamation is always hard to prove and the courts grant little, if any, satisfactory compensation for intangible loss. As a consequence, private parties have little incentive to sue for defamation. Claims for breach of duty of care have thus become a major cause of action during recent years. Interim Measures Article 36 specifies that "[w]here a securities rating agency or any of its staff members fails to diligently fulfill duties or issues documents containing any false record, misleading statement or major omission, it shall be handled according to Article 223 of the Securities Law."[34] In addition, article 223 of the Securities Law specifies that:

> "[w]here a securities trading service institution fails to fulfill its accountability in a diligent and dutiful manner so that any document it formulated or produced has any false record, misleading statement or major omission, it shall be ordered to correct [it], shall have its business proceeds confiscated, shall have its license temporarily or permanently revoked, and shall pay a penalty of between one and five times its business proceeds."[35]

Ostensibly, there is a vehicle to sue unscrupulous credit rating agencies. But in practice, litigation is far more difficult for both plaintiffs and judges to process. In China's legal system, there is no systematic theory of fiduciary duty because the notion of fiduciary duty was transplanted from common law jurisdictions.[36] It is different from the American fiduciary duty system, which includes fiduciary duties in trust, guardianship, agencies and partnership.[37] Chinese courts often find it hard

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[33] *See* Carsten Thomas Ebenroth & Thomas J. Dillon, Jr., *The International Rating Game: An Analysis of the Liability of Rating Agencies in Europe, England, and the United States*, 24.3 LAW & POL'Y IN INT'L BUS. 783 (1993).
[34] *See* Interim Measures, *supra* note 12, at art. 36.
[35] 2005 Securities Law, *supra* note 13, at art. 223.
[36] *See* Weng Xiaochuan, Anatomy of US Hostile Takeover Regulation: A Comparative Perspective of American and Chinese Takeover Regulations Judicial Independence in China (on file with author), at 7.
[37] *See* D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399 (2002) (discussing the U.S. legal system of fiduciary duties and proposing a new theory for unifying them).

to define what a fiduciary duty is or to adjust the standard of review case by case. These systemic imperfections impede private parties from predicting the results of a lawsuit. For this reason, many private parties do not receive fair remedies.

IV. CREDIT RATING IN THE UNITED STATES

A. Development of the Credit Rating Industry in the US

Rating agencies in the United States are organizations that issue ratings regarding the creditworthiness of an entity or a financial product of an entity.[38] Their clients include credit issuers, investors, or other market participants whom the rating agencies charge for the service of processing relevant information. Rating agencies usually use a quantitative or qualitative model to determine the creditworthiness of the subject by analyzing relevant financial information provided by their clients.[39] One of the distinctive characteristics of credit ratings is that they usually focus on long-term risks. Thus they tend to balance accuracy with stability in their assessment.[40] This is partly due to the methodology the rating agencies adopt by incorporating franchise value evaluation, financial statement analysis, management quality and scenario analysis in their rating processes.[41] Rating agencies exert influence on the credit markets by acting as middlemen filling the information gap between issuers and potential investors.

The credit rating system was first developed in the early twentieth century as a subscription-based business.[42] The service was initially aimed at providing investors with information about the quality of corporate bonds. During that time, individual investors were the main clients of rating agencies, as they provided revenues for agencies through subscription fees.[43] Before 1975, the ratings industry remained primarily an enforcement tool for individual issuers and prospective creditors, who were the direct beneficiaries of the credit rating service.

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[38] *See* Caitlin M. Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors*, 50 B.C. L. REV. 1275, 1278 (2009).
[39] *Id*.
[40] Another unique feature of ratings is that they constitute a *de facto* "safety net" for auditors, as they serve a screening function. As federal agencies increasingly base their regulatory decisions on the reports of rating agencies, the credit rating agency increasingly acts as a semi-public gatekeeper tasked with maintaining the general order of the financial markets. We discuss this view later in this essay. *See also* Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach For Rating Agency Accountability*, 87 N.C. L. Rev. 1011, 1018 (2009).
[41] *See* Mulligan, *supra* note 38, at 1278–79.
[42] *See Moody's History: A Century of Market Leadership*, MOODYS.COM, http://v3.moodys.com/Pages/atc001.aspx (last visited Oct. 10, 2010).
[43] *See* Mulligan, *supra* note 38, at 1279.

A major change in the role of rating agencies took place in 1975, when the SEC established the concept of NRSROs through the no-action letter process.[44] Once a rating agency is recognized as an NRSRO, the designation is not subsequently reviewed and is generally only revoked for serious malpractice.[45]

Since the late 1970s, the U.S. federal government began to rely increasingly on the rating agencies to make regulatory decisions.[46] For example, the U.S. Department of Education uses ratings evaluated by NRSROs to set standards of financial responsibility for institutions wishing to participate in student financial assistance programs. Also, several state insurance codes rely either directly or indirectly on NRSRO ratings to determine appropriate investments for insurance companies.[47] Congress also incorporated security ratings into other financial regulatory measures, including the Federal Deposit Insurance Act, which prescribes that corporate debt securities are not investment grade unless they are rated in one of the four highest categories by at least one NRSRO.[48] These situations transformed rating agencies from a private enforcement tool into a semi-public gatekeeper.[49]

The result of this transformation is two-fold. First, it greatly expanded the influence of rating agencies, especially agencies acknowledged as NRSROs by SEC. The federal government's reliance on credit ratings inadvertently created leverage in favor of rating agencies vis-à-vis investors, creditors, and other market participants.[50] While those interest groups developed a growing dependence on credit ratings for their decision-making, credit issuers had an even stronger incentive to secure high credit ratings in order to obtain the accompanying economic privileges.[51] All this made rating agencies a crucial and indispensible link in the security markets.

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[44] The SEC first adopted the term "NRSRO" in 1975 for determining capital charges on different grades of debt securities under the Net Capital Rule. The rule requires broker-dealers to deduct from their net worth certain percentages of the market value of their proprietary securities. The SEC determined that it was appropriate to apply a lower deduction for securities rated "investment grade" by a credit rating agency of national repute, as that would demonstrate that those securities typically were more liquid and less volatile in price than other lesser-rated securities. The requirement that the credit rating agency be "nationally recognized" was designed to ensure that its ratings were credible and reasonably relied upon by the marketplace. *See* SEC Report, *supra* note 6, at 6.

[45] *Id*.

[46] *Id*. at 6–8.

[47] *Id*.

[48] *Id*.

[49] By 2003, eight federal statues, forty-seven federal regulations and more than one hundred state laws and regulations had been written with reference to NRSRO ratings. *See* Mulligan, *supra* note 38, at 1285–86.

[50] *See* Manns, *supra* note 40, at 1035–36.

[51] *Id*.

Second, the transformation of rating agencies' status from private to semi-public institutions changed the dynamics between rating agencies and their beneficiaries.[52] Due to the huge economic rewards accorded to highly rated organizations, debt issuers actively seek the service of authoritative rating agencies like NRSROs.[53] In an effort to secure a high rating, issuers sometimes purchase the consulting services of rating agencies regarding management structure, for example, and implement their advice.[54] The old subscriber-based tradition thus became obsolete as issuers replaced the investor as more direct patrons of the credit rating agencies.[55] As a result, there is a close relationship between rating agencies and issuers and a disconnect between rating agencies and the audience that relies on the credit ratings for decision-making.

B. The Aftermath of the Enron Scandal and the Subprime Mortgage Crisis

The credibility of rating agencies faced grave challenges during the Enron crisis in 2001 and again in the recent subprime mortgage crisis. This led to serious scrutiny of the systematic weaknesses of the credit rating agencies by Congress and academia.

In late 2001, Enron announced bankruptcy four days after three major NRSROs downgraded its credit rating.[56] Investors, the federal government, and the public blamed the rating agencies for the delay in downgrading Enron, as they primarily relied on NRSROs as the frontline gatekeeper.[57] Public scrutiny of the credit rating system came later, in October 2002, when Congress held a hearing regarding heightened oversight for the rating agencies.[58] Pursuant to the Sarbanes-Oxley Act of 2002, the SEC conducted its own survey, and later published findings claiming that the SEC's oversight on rating agencies was necessary to improve transparency and enhance the orderliness of the industry.[59] Soon after, in 2006, Congress enacted the Credit Rating Agency Reform Act, granting the SEC statutory authority to monitor rating agencies, which was implemented by the SEC in 2007.[60]

The rating agencies were questioned again in 2008 during the subprime mortgage crisis. Many subprime residential mortgage-backed

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[52] *Id*.
[53] *Id*.
[54] Mulligan, *supra* note 38, at 1294.
[55] Manns, *supra* note 40, at 1015.
[56] The equity holders of Enron lost over sixty billion dollars, while the creditors of Enron held thirteen billion dollars of debt. *Id*. at 1040–41.
[57] Mulligan, *supra* note 38, at 1284–85.
[58] *Id*. at 1285.
[59] *Id*. at 1287.
[60] *Id*. at 1287–88.

securities (RMBS) and collateralized debt obligations (CDOs) defaulted and were subsequently subject to ratings downgrades.[61] While economic observers admitted that other private actors were also to blame for the crisis, including mortgage brokers, investment banks, and purchasers who took excessively high risks, rating agencies were among those held as the most culpable.[62] With the emergence of increasingly globalized financial markets, increasingly complex financial products and services, and the expanding debt market, investor's reliance on rating agencies as the frontline screener has only been growing, despite all its shortcomings. Yet once again, rating agencies were viewed as failing in their duty as gatekeeper to filter out unqualified entities and toxic financial products. This time, commentators summarized the weakness of the credit rating system as a combination of lax oversight by the SEC, fatal shortcomings of corporate self-governance, gross negligence on the part of rating agencies, and compromised corporate integrity.[63]

C. Problems of the U.S. Credit Rating Industry, and Solutions

Some commentators posit that there are three major concerns regarding the credit rating system: lack of competition, huge conflicts of interest, and accountability issues of rating agencies. These three issues have long been at the heart of the controversy over the credit rating industry and its possible reform even before the subprime mortgage crisis.[64] In response, the judicial system and the SEC—armed with the regulatory authority provided in the Credit Rating Agency Reform Act of 2006—created regulations and oversight measures targeting the three issues.

1. Remedies for the Lack of Competition

The three most reputable NRSROs in the United States—also known as the "Big Three"—are Moody's Investor Services, Fitch Ratings, and Standard and Poor's.[65] The three rating agencies issue ninety-eight percent of all ratings.[66] The Big Three have dominated the credit rating market as early as 1975 after being designated as NRSROs by the SEC.[67]

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[61] *Id*. at 1289.

[62] The rating agencies' strongest defense against critiques of their role in the subprime mortgage crisis probably is that both RMBS and CDO are designed specifically to take advantage of loopholes in agencies' evaluation models in order to secure high ratings. *See* Manns, *supra* note 40, at 1042.

[63] *Id*. at 1039.

[64] Mulligan, *supra* note 38, at 1295–97.

[65] *Id*. at 1279.

[66] *Id*.

[67] *See* SEC Report, *supra* note 6, at 5.

Concerns arose about a monopoly of the credit rating market by the Big Three, as a dearth of competition usually leads to deterioration in products and services and breeds corruption within an industry.[68] Also, questions arose regarding entry-level requirements for recognition as an NRSRO.[69]

Before the Credit Rating Agency Reform Act of 2006, no clear definition pertaining to an NRSRO or guidelines regarding the qualifications for NRSRO were available.[70] In an effort to standardize the credit rating industry, and alleviate public frustration over the lack of credibility of rating agencies, Congress enacted the Credit Rating Agency Reform Act of 2006 granting the SEC authority to govern the application process of an NRSRO.[71] In particular, it required the SEC to set clear standards and criteria regarding the application and approval of an NRSRO.[72] Subsequently, the SEC promulgated a guide entitled "Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations," in which the SEC gave a brief outline of the application procedure and listed information to be disclosed by institutions wishing to become an NRSRO.[73] It was believed that following this type of formalistic approach would improve transparency and promote competition among rating agencies.

While critics doubt that the Credit Rating Agency Reform Act of 2006 will change the dominant status of the Big Three in the short term,[74] most observers believe it will help spur competition in the long run.[75] As of late 2011, there are nine NRSROs in the United States, although the

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[68] *Id*. at 24.

[69] *Id*.

[70] It was partly due to the fact that before the Credit Rating Agency Reform Act of 2006, the SEC did not have the statutory authority to oversee rating agencies. *See* Credit Rating Agency Reform Act, *infra* note 72. Some laissez-faire commentators were worried that SEC's interference would disrupt the self-regulation of the credit rating industry. *See* Mulligan, *supra* note 38, at 1286–87.

[71] Mulligan, *supra* note 38, at 1286–87.

[72] *See* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1327–29 (2006) [hereinafter Credit Rating Agency Reform Act] (codified as amended at 15 U.S.C. 78a & 78o-7), *available at* www.gpo.gov/fdsys/pkg/STATUTE-120/pdf/STATUTE-120-Pg1327.pdf.

[73] *Id*.

[74] To accumulate skills, capital and public acknowledgement needs time, and the mere recognition of an NRSRO by the SEC is far from sufficient for a new NRSRO to survive the market. Just because smaller fish are now allowed to enter the market, it does not mean the Big Three will be much pressured, at least not in the short term. Also some commentators point out that the market probably does not need any more rating agencies, as the current number proves sufficient. Another concern as to spurring competition is the phenomenon of rating shopping. As issuers are now able to shop around for better ratings, they have more leverage than before. Therefore in order to attract clients, rating agencies may compromise on their autonomy, and the market as a whole will suffer. *See* Mulligan, *supra* note 38, at 1292.

[75] *Id*.

Big Three are still the tycoons in the credit rating markets.[76] Observers point out that the sheer number of new rating agencies will exert pressure on the Big Three, and that the burgeoning smaller rating agencies will claim greater market share, in turn restructuring the credit rating industry.[77]

2. Remedies for Conflicts of Interest

As mentioned above, because numerous federal laws and regulations tie credit ratings to the ability to issue debt; the landscape of credit ratings has been transformed into one where it is almost mandatory for issuers to purchase ratings from rating agencies.[78] A more intimate connection therefore exists between rating agencies and issuers—while the direct financial tie between rating agencies and investors becomes more attenuated.[79] This situation provides incentives for rating agencies to turn a blind eye to some suspicious behavior that otherwise might lead to downgrades.[80] Enron is a fine example of this systemic shortcoming. In addition, rating agencies now provide consulting services where they recommend certain corporate structures and asset allocations that translate into higher ratings.[81] Some are suspicious that when a client purchases and follows consulting advice, they are more likely to obtain a high credit rating.[82] This leads to concerns that rating agencies will be biased against the issuers who do not purchase their consulting services and will tend to be more lenient to the ones who do.[83]

In the Credit Rating Agency Reform Act of 2006, Congress specifically targeted the issue of NRSROs' management of conflicts of

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[76] The other seven NRSROs are: A.M. Best Company, Dominion Bond Rating Service, Egan-Jones Rating Company, Japan Credit Rating Agency, LACE Financial Corp, Rating Investment Information, Inc., and Realpoint, LLC. *See Credit Rating Agencies—Globally*, DEFAULTRISK.COM, http://www.defaultrisk.com/rating_agencies.htm (last visited Oct. 1, 2010).
[77] Mulligan, *supra* note 38, at 1296–97.
[78] *Id*. at 1285–86.
[79] *See* Manns, *supra* 40, at 1022.
[80] *Id*.
[81] SEC Report, *supra* note 6, at 45.
[82] *Id*.
[83] Rating agencies usually respond to these concerns by arguing that the financial remuneration they obtain from issuers only occupy a small percentage of their total income. In addition, they highly value objective and accurate ratings, which is crucial to their reputation, and they indicate that they will in no way compromise on that for mere short-term gain. However, criticism of this reputational defense points out that good faith alone is not enough to mitigate financial interest, however small; while public scrutiny may play a part in monitoring rating agencies, it cannot totally offset the market influence. *See* Manns, *supra* 40, at 1048.

interests with its patrons.[84] The SEC expressly mandated disclosure—or otherwise the prohibition—of any business affiliation between an NRSRO and obligors on which the agency provided ratings, where the NRSRO might offer higher crediting ratings in compensation or as a means to acquiring leverage.[85] In addition, the SEC prohibited an NRSRO from all forms of coercive practices whereby the NRSRO may condition a better credit rating on purchase of its consulting services, or require a portion of the client's financial instruments to be rated by it.[86] Without any more fundamental change to the "issuer-pays" model, such measures can be seen as progress towards regulating such relationships within the existing framework.

3. Remedies for Agencies' Lack of Accountability

Suits against rating agencies usually come from two sources: issuers who allege that their financial product was poorly rated, or by investors who suffered loss due to their reliance on the ratings.[87]

In the first case, issuers usually seek to establish a defamation or libel claim, alleging that the negative ratings are not consistent with the actual creditworthiness of their financial product and claiming economic harm ensuing from such ratings. Usually, courts will require plaintiffs to establish three elements to sustain a claim of defamation: (1) that the publication of such ratings is a factual allegation, not mere opinion; (2) that the plaintiff is a private and not a public institution or organization; and (3), that the subject matter of such rating is of private concern.[88] Of the three elements, the first generally proves to be the biggest hurdle for issuers. Rating agencies traditionally hold out their ratings as journalistic

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[84] *See* Credit Rating Agency Reform Act, *supra* note 72, at § 15E(h) (requiring NSROs to "establish, maintain, and enforce written policies and procedures reasonably designed . . . to address and manage any conflicts of interest that can arise from such business," and authorizing the SEC to issue final rules requiring management and disclosure of such conflicts of interest).

[85] *See* Credit Rating Agency Reform Act, *supra* note 72, at § 15E(h).

[86] *See id*. at § 15E(i) ("The Commission shall issue final rules . . . to prohibit any act or practice relating to issuance of credit ratings . . . that the Commission determines to be unfair, coercive or abusive, including any practice relating to— (A) conditioning or threatening to condition the issuance of a credit rating on a purchase by the obligor or an affiliate thereof of other services or products . . . of the [NSRO]; . . . (C) modifying or threatening to modify a credit rating or otherwise departing from its adopted systematic procedures and methodologies in determining credit ratings, based on whether the obligor, or an affiliate of the obligor, purchases or will purchase the credit rating or any other service or product of the [NSRO] or any person associated with such organization.").

[87] *See* Jonathan S. Sack & Stephen M. Juris, *Rating Agencies: Civil Liability Past and Future*, 238 N.Y. L.J. 88 (2007), *available at.* http://www.maglaw.com/publications/articles/00144/_res/id=Attachments/index=0/07011070002Morvillo.pdf.

[88] *See* Ebenroth & Dillon, *supra* note 33, at 834.

opinions, which are therefore protected under the First Amendment.[89] This journalistic opinion defense has provided rating agencies with virtual immunity from civil liability for their ratings. In recent years, in order to sustain a defamation claim, courts also put emphasis on proof of actual malice by rating agencies in their issuance of a negative rating.[90] Even in situations where the issuers, instead of raising a defamation claim, are primarily seeking to establish negligence and breach of good faith against rating agencies based upon a contractual relationship between the two, some federal courts have struck down such a cause of action, reasoning that issuers must still prove actual malice.[91]

As for suits brought by investors, there are two categories of cases: first, suits brought by subscribers who made business decisions according to ratings published by rating agencies to which the investor subscribed; and second, suits brought by investors who contracted directly with rating agencies for consultancy.[92]

In the case of subscribers, the major hurdle is to establish a degree of privity as a third party beneficiary of such ratings before they can further their tortious claim.[93] As for the second group of investor suits, the plaintiffs usually seek to establish a negligence claim by way of negligent misrepresentation.[94] However, even in these cases, rating agencies' First Amendment defense may defeat such claims.[95] Courts may still find such ratings to be journalistic opinions and require investors to prove actual malice,[96] or courts may determine that the investors' reliance was unreasonable in light of rating agencies' disclaimer that their

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[89] *See* Sack & Juris, *supra* note 87 ("The rating agencies traditionally have avoided liability for their ratings, in part because of the presumption that they are independent financial reporters.").

[90] *See Compuware Corp. v. Moody's Investors Servs. Inc.*, 499 F.3d 520, 527–28 (6th Cir. 2007) (affirming the District Court and finding that Compuware had failed to provide sufficient evidence of actual malice to withstand summary judgment).

[91] *See id*. at 531.

[92] Ebenroth & Dillon, *supra* note 33, at 803–05.

[93] *Id*. at 803.

[94] Or via a common law fraud claim. But the standard is similar to that applicable to a negligent misrepresentation claim. Courts often shift the burden of proof on the plaintiff to show the following elements are present, in order to sustain a negligent misrepresentation claim: (1) a false statement of material fact; (2) carelessness or negligence in ascertaining the truth of the statement by defendant; (3) an intention to induce the other party to act; (4) action by the other party in reliance on the truth of the statements; (5) damages to the other party resulting from such reliance; and (6) a duty owed by defendant to plaintiff to communicate accurate information. *Quinn v. McGraw-Hill Companies, Inc.*, 168 F.3d 331, 335 (7th Cir. 1999).

[95] *See In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, 511 F.Supp.2d 742, 809–10 (2005).

[96] *See id*. at 811–12.

ratings were not recommendations to purchase or invest in such financial instruments.[97]

While the First Amendment defense has greatly shielded rating agencies from civil liability, there are heated discussions over whether it would be appropriate to expose rating agencies to greater accountability.[98] Moreover, the recent subprime mortgage crisis has put more pressure on judicial and legislative systems to reassess their approach to the credit rating industry. The Restoring American Financial Stability Act of 2009 required heightened transparency by NRSROs as to their credit rating methodologies, internal controls, and reports of their independence from issuers;[99] together with the Wall Street Reform and Consumer Protection Act, this showed a general legislative tendency towards enhancing the scope of rating agencies' liability and shrinking areas in which they may enjoy immunity.[100]

V. INSPIRATIONS AND SUGGESTIONS FOR CREDIT RATING IN CHINA

A. Suggestion on the Lack of Competition and Rating Shopping Issues

One hurdle for promoting competition in China's credit rating industry is the lack of definitive legal guidance. As mentioned before, while several regulatory ordinances have been issued throughout the years, the only one providing substantive rules specifically applicable to credit agencies has been the Interim Measures.[101] However, even the Interim Measures ordinance has its critical defects: not only does it impose high entry requirements on applicants seeking to become nationally-recognized credit rating agencies,[102] but it is ambiguous on the criteria CSRC is to use in qualifying or disqualifying an applicant. As a result, an applicant has to jump two hurdles before its application can be approved—first, it has to meet the high threshold requirement; and second, not knowing how CSRC

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[97] *See Quinn v. McGraw-Hill Companies, Inc.*, *supra* note 94, at 336.

[98] *See* Mulligan, *supra* note 38, at 1296.

[99] Restoring American Financial Stability Act of 2009 (Comm. Print 2009), §§ 931–32, *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=943242e1-ca66-411c-89e2-8954eb3fc085; a section-by-section summary of the Act, proposed by Senator Dodd, is available at http://www.politico.com/static/PPM130_section_by_section_11_16_09.html (last visited Oct. 11, 2010).

[100] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010), *available at* http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/content-detail.html (last visited Oct.12, 2010).

[101] *See* Interim Measures, *supra* note 12.

[102] *See* Interim Measures, *supra* note 12, at Provisions 7(1)–(2).

will judge its application, it faces unpredictable, if not arbitrary administrative decisions. We will now discuss those two problems in detail.

First, the entry requirement listed in the Interim Measures is too high a threshold for most applicants. For example, Provision 7(1) requires a qualified credit agency to have total net assets of at least RMB 20 million.[103] This provision alone bars most private agencies at the doorstep. In addition, Provision 7(2) requires qualified credit agencies to have personnel consisting of at least twenty credit rating evaluators, ten of whom have to be senior evaluators with more than three years of working experience.[104] Considering the fact that the credit rating industry in China was only established in 2000, evaluators with such experience are still rare even in a burgeoning industry.[105] In fact, there is currently a deficit of professional evaluators working for credit rating agencies in China, which means that CSRC cannot afford to be so demanding yet, and should not set the bar so high.[106] These two provisions, taken together, set daunting requirements on both the "hard" and "soft" assets of the potential applicant agencies.

The situation China faces differs from that in the United States. The credit rating market in the United States grew and matured as early as the start of the 1900s.[107] By the 1950s, the monopoly of the Big Three emerged, and fundamental parameters of the industry had been established and acknowledged. Insurgent smaller rating agencies unsatisfied with a static market had over a century to grow and amass a fair amount of knowledge, capital, and personnel. In view of the relatively short history and insufficient development of China's credit rating industry, a lower entry requirement—regarding both capital and personnel—would be more helpful for the purpose of promoting competition in the industry, than is possible through the mere listing of application procedures.[108] Concededly, this may for a certain period of time dilute the average quality of rating services. However, many scholars believe that breaking the monopoly of the Chinese "Big Five" and encouraging fledgling rating agencies would, in the long run, create a healthy industry, which would be worth the temporary downgrade in service quality for the interim.[109]

Second, while the Interim Measures lists in detail the procedural requirements for applicant submissions, including mandatory disclosure of certain information, the statutory language mentions nothing regarding the substantive criteria CSRC uses in evaluating the application material after

[103] *Id.* at Provision 7(1).
[104] *Id*. at Provision 7(2).
[105] *See* Shi Fang et al., *supra* note 16, at 396.
[106] *Id*.
[107] *See Moody's History*, *supra* note 42.
[108] *See* Wang & Dong, *supra* note 8, at 63–64.
[109] *Id*.

it has been submitted. CSRC is also silent in response to the public demand for exact doctrinal guidance on how it assesses applicants; for example, the grounds for disqualification, and any redeeming measures disqualified applicants can take, are unclear. CSRC's ambiguous posture in this regard upsets the public, and furthers commentators' suspicions about the lack of transparency and democracy in CSRC's internal governance mechanisms.[110]

To improve the situation, the Chinese state legislature should refer to the precedents of its U.S. counterpart. The Credit Rating Agency Reform Act of 2006 serves as a model statute for setting criteria and standards for evaluating the qualification of applicants. In particular, it requires the SEC to state grounds for a denial of licensure, based on an applicant's rating methodologies, internal structures, code of ethics, and implementation of policies against misuse of confidential information, among other factors.[111] Similarly, China's legislature may want to build a more substantial and workable framework, comparable to that in the United States, for providing guidance and clarification on the relevant criteria.

When it comes to the regulation of rating shopping, scholars believe that in every country it is necessary to scrutinize and strictly supervise conflicts of interest between rating agencies and issuers.[112] As to the supervision and regulation of such conflicts of interest, CSRC is at a slightly more advantageous position than the SEC, because the CSRC is designated with full authority by the State Council and relevant statutes to regulate credit rating agencies.[113] The Interim Measures clearly state that CSRC has the authority to supervise and penalize rating agencies which abuse the credit rating system.[114] In addition, the Interim Measures prohibit rating agencies from rating any institutions in which the agencies have more than a 5% share.[115] The Interim Measures create a duty of "recusal" for rating agencies, banning them from rating institutions in which any agency employee or close relatives of such employee work. It also applies to require recusal of an agency where one or more of its employees hold more than 5% of the equity interests in the institution to be rated,[116] sit on the board of directors, or work as a senior executive,[117] as a legal or financial consultant, or as an auditor,[118] or have previously

[110] *Id*.
[111] *See* Credit Rating Agency Reform Act, *supra* note 72, at § 15E(a)(2)(A)–(C).
[112] *See* SEC Report, *supra* note 6; Wang & Dong, *supra* note 8.
[113] *See* Interim Measures, *supra* note 12.
[114] *Id*.
[115] *Id*. at Provision 12(1).
[116] *Id*. at Provision 13(1).
[117] *Id*. at Provision 13(2).
[118] *Id*. at Provision 13(3).

engaged in transactions with such institution accumulating to RMB 500,000 or more.[119]

However, these provisions are only aimed at direct conflicts of interest. The P.R.C. state legislature may want to expand the scope of this provision to include indirect conflicts, in a way similar to what the Credit Rating Agency Reform Act of 2006 does.[120] Such indirect conflicts arise in situations where the rating agencies may be biased in their rating when offering rating consulting services to clients, as well as other situations involving possible favoritism on behalf of rated companies, which tend to arise as a result of a rated-client oriented system.

B. Thoughts on Liability of Rating Agencies

As mentioned before, to improve the performance of rating agencies in China, it is crucial to improve private enforcement. However, the major current obstacle to an effective system for private enforcement is the incompleteness of applicable law. As in other countries, defamation, duty of loyalty and duty of care causes of action are a major feature under the current formal Chinese legal framework. Unfortunately, almost none of these casues of action turns out to be effective in practice.

According to Chinese law, a business organization can claim defamation when its reputation is infringed upon.[121] Unlike in America, freedom of speech is not a valid defense,[122] even though such rights are protected under several provisions in the Constitution of People's Republic of China.[123] Courts will generally not even hear a case in which claims are based solely on constitutional rights.[124] Therefore, a freedom

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[119] Interim Measures, *supra* note 12, *at* Provision 13(4).

[120] *See* Credit Rating Agency Reform Act, *supra* note 72, at § 15E(h)–(i).

[121] *See* Zhonghua Renmin Gongheguo Minfa Tongze [中华人民共和国民法通则] [General Principles of Civil Law] art. 120 (1986) (P.R.C.) ("If a citizen's right of personal name, portrait, reputation or honour is infringed upon, he shall have the right to demand that the infringement be stopped, his reputation be rehabilitated, the ill effects be eliminated and an apology be made; he may also demand compensation for losses."), *available at* http://www.china.org.cn/china/LegislationsForm2001-2010/2011-02/11/content_21898337.htm (Chinese version available at http://www.people.com.cn/GB/shehui/8217/39932/2944727.html). The General Principles of Civil Law is the civil law code of People's Republic of China.

[122] *See* Zhang Hong [张红], *Shishi Chenshu, Yijian Biaoda yu Gongyixing Yanlun Baohu* [事实陈述，意见表达和公益性言论保护] [*Protection of Factual Statements, Expression of Opinions and Speech in the Public Interest*], 3 FALÜ KEXUE [L. SCIENCE] 106 (2010).

[123] *See, e.g.*, XIANFA [中华人民共和国宪法] arts. 35, 41, 47 (1986), *available at* http://english.people.com.cn/constitution/constitution.html (Chinese version available at http://www.gov.cn/gongbao/content/2004/content_62714.htm).

[124] *See* Minshi Anjian Anyou Guiding［民事案件案由规定］[Rules on Causes of Action in Civil Cases] (2007) (P.R.C.) (as amended, 2011), *available at* http://www.law-lib.com/law/law_view.asp?id=344334. The Rules on Causes of Action in Civil Cases

of speech-based defense is invalid for rating agencies in China. However, this does not mean defamation suits will be more favorable to the plaintiff. While there are a series of judicial comments and notes on the definition of defamation, they are just enumerated as a laundry list of possible situations which could constitute defamation.[125] The law is silent on how to measure damage, which is now a major problem for defamation suits. In most cases, the courts are reluctant to award large damages based on intangible harm alone. This is partly due to the fact that the intangible assets market is underdeveloped. The courts' reluctance also results from the difficulty of proving a causal relationship between defamatory expression and later substantial harm suffered. The plaintiff usually cannot get satisfactory compensation from a defamation suit. To solve the problem of the lack of any defined way for conducting damage measurement, a statutory or judicial clarification is needed. But this will require a more mature market overall, that better understands intangible loss.[126]

While the obstacles to defamation suits in China will not be eliminated anytime soon, the legal framework of fiduciary duty can still be improved as an alternative to facilitate more effective private enforcement. As mentioned previously, although the Interim Measures Articles 36 and 223 of the Securities Law have epitomized the contour of rating agencies' fiduciary duty, judges still find it hard to apply the rules. The law says nothing about which party should bear the burden of proof in the adjudication of such matters.

Fiduciary duties are highly contextual[127] and therefore are one of the most elusive concepts in Anglo-American law.[128] There are several

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constitute a judicial explanation by the Supreme People's Court on what kind of cases can be admitted and heard by a court.

[125] *See* Zuigao Renmin Fayuan Guanyu Guanche Zhixing "Zhonghua Renmin Gongheguo Minfa Tongze" Ruogan Wenti de Yijian (Shixing) [最高人民法院关于贯彻执行‹‹中华人民共和国民法通则››若干问题的意见(试行)] [Several Issues Concerning the Implementation of the 'General Principles of Civil Law of the People's Republic of China' (Trial Implementation)] § 140 (1987) (P.R.C.) (providing a judicial explanation of the civil law code of People's Republic of China), *available at* http://www.law-lib.com/law/law_view.asp?id=203; *see also* Zuigao Renmin Fayuan Guanyu Shenli Mingyuquan Anjian Ruogan Wenti de Jieda [最高人民法院关于审理名誉权案件若干问题的解答] [Answers of the Supreme People's Court on Several Issues Concerning Defamation Adjudications] Q7 (1993) (P.R.C.) (providing a judicial explanation on the appropriate conduct of defamation adjudications), *available at* http://www.law-lib.com/law/law_view.asp?id=239.

[126] Intangible assets used to be a puzzling issue in the U.S. too. U.S. corporate law used to deny the legitimacy of purchasing shares by contributing intangible assets, because it was very hard to value the intangible assets. *See* William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261 (1992).

[127] *See, e.g.*, Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399 (2002); *see also* Deborah A. DeMott, *Beyond Metaphor: an Analysis of Fiduciary Obligation*, 1988 DUKE L. J. 879 (1988).

compelling theories to explain the fiduciary relationship. The most widely accepted proposition is the contract theory by Frank Easterbrook and Daniel Fischel. According to this theory, "a 'fiduciary' relation is a contractual one characterized by unusually high costs of specification and monitoring."[129] In the credit rating context, it is very crucial to determine the contractual relationship in order to decide whether a fiduciary relationship exists. Therefore, if there is no contract between plaintiff and defendant, a fiduciary relationship will not exist. This is the simplest and therefore the most workable principle for guideline-reliant Chinese judges.[130]

Some Chinese scholars have already embarked on studies regarding the burden of proof issue.[131] According to rating guidelines issued by CSRC, instead of proving the correctness of the result *per se*, the litigants should focus more on proving that the rating result is derived through a proper procedure.[132] Imposing this burden of proof on a plaintiff usually means the plaintiff will lose. This is because credit rating is a highly professionalized and information-demanding business, and usually the only strategy plaintiffs can adopt is to make a causation claim. This claim is almost always rebutted by hindsight bias theory.[133]

If the court instead requires the defendant rating agency to prove that its rating results are appropriate, then rating agencies will have to disclose their rating methodology in court. This will improve the transparency of the rating procedure and rating methodologies employed by agencies. In the meantime, plaintiffs have a chance to rebut the defense as long as agencies are shown to have failed to follow proper

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[128] *See* DeMott, *supra* note 127, at 879.
[129] *See* Frank H Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425, 427 (1993).
[130] *See* Charlie Xiao-Chuan Weng, *Assessing the Applicability of the Business Judgment Rule and the 'Defensive' Business Judgment Rule in the Chinese Judiciary: A Perspective on Takeover Dispute Adjudication*, 34 FORDHAM INT'L L.J. 124, 133–138 (2010) (discussing the composition of China's corporate judiciary, and the manner in which economically-dependent judges tend to prefer guidance from higher-level courts over making their own judgments as to particular cases).
[131] *See* Luo Peixin [罗培新], *Hou Jinrong Weiji Shidai Xinyong Pingji Jigou Falü Zeren zhi Wan Shan* [后金融危机时代信用评级机构法律责任之完善] [*Improvements in Legal Accountability of Credit Rating Agencies in the Aftermath the Financial Crises*], 7 FAXUE ZAZHI [J. OF L.] 5 (2009).
[132] *See* Guidelines for Issuing Credit Reports for the Bonds of Securities Companies by Credit Rating Agencies, *supra* note 12; *see also* Luo, *supra* note 131, at 7.
[133] Experimental psychology has shown that on hindsight, people consistently arrive at an outcome that could have been anticipated in foresight. *See* ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD 119–20 (1988); Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 335, 341–43 (Daniel Kahneman et al. eds., 1982); Baruch Fischhoff & Ruth Beyth, *'I Knew It Would Happen': Remembered Probabilities of Once-Future Things*, 13 ORG. BEHAV. AND HUM. PERFORMANCE 1, 1–16 (1975).

procedures and legitimate methods. However, if the rating result is derived through such appropriate procedures and methods, then agencies cannot be held liable for breach of fiduciary duty. Otherwise, the credit rating industry would become an excessively high-risk business.