EXPLANATORY MEMORANDUM TO

THE CREDIT RATING AGENCIES (CIVIL LIABILITY) REGULATIONS 2013

2013 No. 1637

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 Council Regulation (EU) No 462/2013 on credit rating agencies (OJ L 146, 31.5.2013, p. 1) ("the Regulation") imposes civil liability on credit rating agencies ("CRAs") where they commit infringements of certain EU law requirements either intentionally or with gross negligence. This new statutory liability is contained in Article 35a of Council Regulation (EC) No 1060/2009 (the "2009 Regulation"). Article 35a was inserted into the 2009 Regulation by the Regulation. It is open to Member States to provide for the interpretation and application of several terms used in Article 35a. This instrument seeks to make such provision in a way that ensures the civil liability imposed by Article 35a matches, so far as is possible, pre-existing forms of civil liability in UK common law to which CRAs are already subject.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Context

4.1 The Regulation is directly applicable and therefore requires no transposition in national law. However, certain key terms within Article 35a have been left to have the meanings they bear in national law. In order to provide legal certainty (in particular because some of these terms may not have well-established meanings in Member States' domestic laws), it is open to Member States to provide for the interpretation and application of such terms in their domestic laws. These terms are "intention", "gross negligence", "impact", "reasonably relied", "caused", "damage", "due care" and "reasonable and proportionate". It is also open to Member States under Article 35a to specify a limitation period for bringing claims and this instrument includes such a limitation period.

4.2 Explanatory Memoranda 17308/11 and 17329/11 on the European Commission proposal for a Regulation and a Directive on credit rating agencies were submitted by Mark Hoban MP (then Financial Secretary to the Treasury) to Lord Roper and William Cash MP on 7 December 2011. The Explanatory Memorandum concerning the Directive was cleared by the House of Lords European Union Sub-Committee on Economic and Financial Affairs and International Trade on 7 February 2012 and the Explanatory Memorandum concerning the Regulation was cleared on 20 March 2012. The Explanatory Memoranda were cleared in the House of Commons by debate on 16 April 2012.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- What is being done and why

7.1 Ratings are produced by CRAs as an indication of their view of the level of credit risk represented by an issuer or a specific debt instrument of an issuer. Investors then use these ratings to inform their investment decisions. However, the value of CRA ratings was widely questioned after the financial crisis. CRAs were criticised for not downgrading companies promptly enough and for having relationships that were too familiar with issuers of financial instruments (with an attendant potential perception of a conflict of interest). It was also perceived that there was a lack of competition in the CRA market.

7.2 In response to these criticisms and concerns, the European Parliament and the Council of the European Union laid down specific rules regarding the operation of CRAs in the 2009 Regulation, which established a registration system for CRAs in Europe, and required them to comply with provisions relating to independence, conflicts of interests, transparency and disclosure, employees, and methodologies. The 2009 Regulation was followed by Council Regulation (EU) No 513/2011 which, amongst other things, inserted into the 2009 Regulation a new annex, Annex III, which contains a list of activities that amount to infringements of certain requirements placed on CRAs, including requirements concerning their organisation, operation and independence.

7.3 On 15 November 2011, the European Commission made further proposals relating to CRAs. These proposals included establishing a statutory means of redress for issuers and investors against CRAs in circumstances where a CRA committed, intentionally or with gross negligence, any of the infringements specified in Annex III to the 2009 Regulation. Political agreement to these proposals was reached on 27 November 2012. A draft of the Regulation was subsequently approved by the Permanent Representative Committee of the European Council on 5 December 2012 and endorsed by the European Parliament on 16 January 2013. The Regulation was published in the Official Journal of the European Union on 31st May 2013 and came into force on 20 June 2013.

7.4 CRAs are already subject to civil liability in the United Kingdom under domestic common law (the tort of negligent misstatement and, in cases where the rating is provided by agreement, under contract law). Article 35a of the 2009 Regulation therefore provides an additional mode of claim against CRAs under United Kingdom law. Article 35a permits Member States to provide for the interpretation and application of certain terms used in the Article in their domestic law. If Member States do not make such provision, the terms would be interpreted and applied by the courts in the context of litigation. In

making provision in respect of the key terms in Article 35a, the Treasury's policy approach has been to minimise the differences between the new EU liability and the existing common law liability by interpreting and making provision for the application of the terms in Article 35a in such a way that, where possible, they conform to equivalent terms in UK law. This is with a view to achieving the following policy objectives:

- reducing regulatory burden on business, by promoting legal certainty; and

- encouraging and enabling competition amongst CRAs by ensuring that the costs of understanding and taking account of the Article 35a liability are as small as possible and do not form a barrier to the entrance of new CRAs to the market.

7.5 However, in the cases of the terms "gross negligence", "reasonable and proportionate" and "damage", we have taken a different approach. This was because it was either not possible to conform definitions to equivalent terms in UK law or the equivalent approach in UK law was not consistent with minimising costs to UK businesses. The Treasury have:

- ascribed to the term "gross negligence" the meaning of recklessness which is a well-established concept in UK law;

- included indicative factors in the instrument to assist the court in considering whether limitations CRAs have sought to place on their liability are "reasonable and proportionate"; and

- defined "damage" in line with national law for the equivalent area, namely tort and contract (in the case where a rating has been ascribed on a solicited basis, under a contract). For issuers or debt instruments which have been the subject of unsolicited ratings, damages are limited to the increase in the financing costs of the issuer resulting from the rating.

7.6 The Treasury have also specified a limitation period for bringing claims under Article 35a of one year beginning from the point that a person discovered that a CRA had committed an infringement listed in Annex III to the 2009 Regulation, or could with reasonable diligence have discovered it.

- Consolidation

7.7 This is a standalone instrument which does not amend or affect any other instrument and therefore consolidation is not required.

8. Consultation outcome

8.1 On 28 February 2013, the Treasury launched an informal, month-long targeted consultation with key stakeholders. Stakeholders were asked to comment on the Treasury's proposed approach to defining terms used in Article 35a and were invited to comment on a working draft of this instrument. They were also invited to attend a stakeholder meeting on 20 March 2013. Those stakeholders included the 'big four' CRAs

(Standard & Poor's, Moody's, DBRS and Fitch Ratings), legal groups (such as the Financial Markets Law Committee), and financial/business groups (including the CBI, ABI and the BBA).

8.2 Responses were received from each of the 'big four' CRAs, who were generally supportive of the Treasury's approach. Many of the points raised in their responses touched on terminology, whilst some of the CRAs explained certain aspects of the rating process which the draft instrument did not accurately capture. Many of the points and suggested changes were reflected or incorporated in the instrument, including modification to reflect the fact that investors may enter into subscription arrangements with CRAs. CRAs also agreed that the limitation period for bringing a claim should be one year.

8.3 Certain CRAs also responded to the Treasury's proposed mechanism to afford them a measure of insolvency protection in the context of claims made under Article 35a, concluding that it was unworkable. This proposal was therefore not proceeded with. Nor was a Treasury suggestion that a specific damages-calculation mechanism could be included in the legislation, which was not supported by the CRAs.

8.4 Certain CRAs suggested further factors to be included in the list of those relevant to determining whether a limitation of liability was reasonable. The Treasury chose not to add factors where they believed this would add unnecessary complexity to, and uncertainty in, the determination of liability.

8.5 Suggestions were received in relation to the calculation and capping of damages under Article 35a claims. Many of the CRAs agreed that the calculation of damages should, where possible, follow the method that exists under UK common law (in the case of claimants who are investors). The Treasury considered it was more appropriate to cap issuers' damages at an amount equal to the increase in their financing costs rather than an amount which is a function of annual fees, as was suggested by one of the CRAs. Finally, the Treasury agreed with the majority view amongst the CRAs that the concept of contributory negligence should apply to determinations of damages under Article 35a.

9. Guidance

9.1 The Treasury consider that guidance is not needed in connection with this instrument since its function is to make provision for the interpretation and application of certain terms in Article 35a of the 2009 Regulation.

10. Impact

10.1 The financial impact on UK businesses of the changes contained within this instrument will be negligible.

10.2 The impact on charities and voluntary bodies is negligible.

10.3 The impact on the public sector is negligible.

10.4 An Impact Assessment has not been prepared for this instrument, which is considered a low-cost measure. As such, a Regulatory Triage Assessment was conducted and subsequently approved by the Regulatory Policy Committee.

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

12.1 The Treasury is required to review the operation and effect of the instrument within a five year period after the instrument comes into force and within every five years after that.

13. Contact

Ali Uppal at the Treasury Tel: 020 7270 1609 or email: ali.uppal@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.