Written response to the Credit Rating Services Bill [B10-2012]

25 May 2012

Mr T. Mufamadi, MP: ST on Finance
Attention: Mr Wicomb
Parliament of RSA
P O Box 15
Cape Town
8000

Dear Sir

Written response to the Credit Rating Services Bill [B10-2012]

Firstly we would like to state for the record that GCR embraces the legislation proposing to regulate the credit ratings industry. We believe it will improve the competitive landscape and whilst the other agencies will certainly be in a position to benefit from a number of exemptions, all credit rating agencies are required to apply for a licence and go through the vigorous due diligence in order to obtain the licence. At the end of the process, we hope to have earned ours, creating a level playing field with the other credit rating agencies, thus broadening our market.

We do not believe it is the intention to downsize the credit ratings industry and that a balance will be found between providing the market with a higher level of transparency, but also applying a balanced approach. With the current draft Bill as it stands, the risk of not being able to employ or retain analysts is high, due to the onerous liability clauses in the draft Bill.

In this regard, we think the key issues are:
1) The draft Bill recognizes a “credit rating” to be an “opinion” about the (future) creditworthiness of an entity or a financial instrument and as such a credit rating is subject to a number of variables and factors which can be unknown and complex in nature, for example economic or industry forecasts, which cannot be qualified as incorrect.

2) The end-users of credit ratings are sophisticated parties active in the financial markets and are not “the average man in the street”. Such sophisticated parties should not be excluded from any responsibility when using credit ratings by enacting legislation that seems to put responsibility only on the shoulders of the credit rating agencies.

3) Section 23 (2) (b) (i) of the draft Bill states that the Registrar must, in performing his or her powers and functions “have regard to international supervisory standards”.

In this regard, in Europe CRAs began by being ruled by REGULATION (EC) No 1060/2009 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL, of 16 September 2009 (known as CRA I) – which

remitted to Member States the establishment of penalties – article 36 – but did not mention the question of liability of CRAs. CRA I was afterwards amended by REGULATION (EU) No 513/2011 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL, of 11 May 2011 (known as CRA II), which basically introduced ESMA and specified penalties (fines and, as a maximum, withdrawal of registration) for each infringement (articles 24 (1), 36 (a) and 36 (b) and Annexes III and IV). This question of liability of CRAs is now being raised by a proposal of the European Commission (now being discussed between the European Parliament and the European Council) to amend again CRA regulations (known as CRA III), and only for intentionally or with gross negligence infringements (article 35 (a) – specifically refer to point 3.4.7 on page 11 of CRA III attached).

Following from the above, our submission and recommended changes can be found below.

Section 19(1)

We note National Treasury's comment that the existing standard of delictual liability under the common law has been incorporated into the Act. However, the fact that credit ratings and credit rating services will now be regulated in terms of the Act significantly alters the legal framework in which CRA's will operate and is likely to effect, in particular, the test for wrongfulness to be applied by our courts in relation to the delictual liability of a CRA. In these circumstances, we are of the view that it would be reasonable to restrict the delictual liability of CRA's to failures to comply with the Act arising from acts or omission of wilful default or gross negligence by the CRA and which have an impact on the rating outcome. This also follows the approach which is likely to be adopted in the equivalent EU Regulations.

We therefore suggest that section 19(1) be replaced with the following: "A credit rating agency may be delictually liable to an investor if such investor suffers any loss, damage or cost caused by the credit rating agency deliberately or with gross negligence failing to materially comply with any provision of this Act, and which has an impact on the credit rating on which such investor has relied."

Section 32(a)

The addition of the words "or any other provisions of this Act" is in our view a surprising and alarming new amendment proposed by National Treasury. It essentially means that any person who commits even the most minor infringement of the Act (even unknowingly and which may easily be remediable) will be guilty of an offence. Clearly the ambit of the statute is much too wide and in many instances the offence is likely to be manifestly inappropriate to the potential sentence that may be imposed, which includes a prison sentence of up to 10 years. We therefore suggest that, as in other similar statutes, for example in Europe, the ambit of the section should be limited to offences arising from infringements of certain, specified provisions of the Act and not just any provision of the Act. Furthermore, we are concerned that there is no express element of mens rea in the proposed wording.

We therefore propose that the wording “or any other provisions of this Act” be amended as follows: “or deliberately contravenes or materially fails to comply with the provisions of this Act, where the infringement in question affected the outcome of the rating”.

Or an alternative option could also be, “or deliberately contravenes or materially fails to comply with the following provisions of this Act: [][Insert specific sections of the Act], where the infringement in question affected the outcome of the rating’.

Section 32(c)

The current wording is too wide, particularly in relation to furnishing “false” information. For example, the “false” information may arise from a simple typographical error without any intent or malice on the part of the person giving such information.

We would therefore suggest that the wording be amended as follows: “Deliberately gives an auditor or compliance officer information which is false, misleading or conceals any material fact.”

Relating to other provisions of the Bill, we would like to make the following suggestions:

Page 5, definition of “structured finance instrument”:

It is difficult to define precisely what a structured finance instrument is because there is no single, uniform definition.

We suggest amending the definition as follows: “means a financial instrument that is of a more complex nature than a standardised financial instrument. Structured finance instruments result from structures and/or programmes that are directly and/or indirectly backed by and/or credit linked to certain assets and/or exposures.”

Page 5, definition of “plain language”

We propose to remove this requirement from the Act. It will be very difficult in practice to write credit rating reports that would qualify as “plain language” for every potential reader. As section 19(1) suggest that “any member of the public” could sue a credit rating agency, this would mean that also persons that are not sophisticated participants of financial markets can sue and could claim that the language used was not “plain” for them.

Section 19(1):

Is it possible to clarify why “member of the public” is included in this clause? It is not understood why an unspecified member of the public should have the opportunity to start a lawsuit against a credit rating agency? This is particularly onerous given the provision on Page 5 Point 5(a)(ii) that requires the use of ‘Plain language’ as it could be reasonably assumed that not all members of the public ‘have average literacy skills and experience in dealing with credit ratings ….’., [the latter

clearly stated in the draft Bill].

We therefore suggest the following wording '…to an investor, in respect of …'

Section 19(3):

It is common practice to use disclaimers and disclose the limitations of the credit rating and/or credit rating process. Sophisticated investors who are in effect the users of credit ratings should be able to understand what a credit rating means and what its limitations are. To state in the Act that a credit rating agency is not allowed to "in any other way" limit or reduce its liability is not appropriate because a rating is merely an opinion, based on an assessment of complex factors, including economic and political factors, none of which can be qualified as incorrect. A rating agency is also reliant on the issuer providing accurate and reliable information. These limitations should be clearly outlined in all published documentation.

We thank you for your time and attention.

Yours faithfully

Melanie Brown
Managing Director

For details concerning the Credit Ratings Services Bill, 2012 please click here
https://globalratings.net/uploads/files/Written_submission_-_GCR_25_May_2012.pdf