

**The civil liability of credit rating agencies in South African law:  
recent developments in comparative perspective**

by

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Figure 1

**List of Abbreviations**

ABS	Asset backed security
BCBS	Basel Committee on Banking Supervision
CDO	Collateralised debt obligation
CDS	Credit default swap
CPDO	Constant proportion debt obligation
EU	European Union
FSB	Financial Services Board
G-20	Group of Twenty Finance Ministers and Central Bank Governors
GFC	Global financial crisis
IOSCO	International Organization of Securities Commissions
ISDA	International Swap and Derivatives Association
JSE	Johannesburg Securities Exchange
MBS	Mortgage-backed security
OTC	Over-the-counter
S&P	Standard & Poor's
SARB	South African Reserve Bank
SIFI	Systemically important financial institution
SIV	Structured investment vehicle
SPV	Special purpose vehicle
UCITS	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
US	United States

## 1. Introduction

The losses caused by the on-going financial crisis now exceed \$4 trillion.<sup>1</sup> This is in addition to the associated social and economic costs that are more difficult to measure.<sup>2</sup> From a litigator's perspective it is not surprising that these massive losses have triggered a very large number of civil claims. In the immediate aftermath of the crisis these claims were mostly run-of-the-mill misrepresentation actions by investors against their investment advisors, but there is now a clear, global trend where plaintiffs are casting their nets more widely and going after the financial actors allegedly responsible for the crisis itself.<sup>3</sup> One class of defendants who fit squarely in this category are credit rating agencies.<sup>4</sup> These financial actors are facing a global push by lawmakers to regulate their operations with, *inter alia*, the express aim of setting parameters for the liability ratings agencies should incur in the publication of ratings.

Just as legislatures are attempting to respond to the crisis with new statutes, so too is judge-made law in common law jurisdictions developing in leaps and bounds. The recent landmark decision from the Federal Court of Australia, *Bathurst Regional Council v Local Government Financial Services*,<sup>5</sup> held for the first time that a ratings agency owes a duty of care to potential investors, breach whereof rendered the rating agency in question liable for all of the losses incurred by the disappointed investors. These developments—whether they originate in a courtroom or at the headquarters of International Organization of Securities Commissions (IOSCO) in Madrid, Spain—will be of great interest to all market participants involved in the sale and structuring of complex credit products.<sup>6</sup> In particular,

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<sup>1</sup> International Monetary Fund 'Crisis and Recovery' *World Economic Outlook*, April 2009, available at <http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/exesum.pdf>, accessed on 18 August 2013.

<sup>2</sup> For instance, South Africa is said to have lost 1 000 000 jobs as a direct consequence of the financial crisis. See e.g. Claire Bisseker 'Unemployment rises for under 25 year olds' *Financial Mail*, 1 August 2013, available at <http://www.fm.co.za/business/fox/2013/08/01/unemployment-rises-for-under-25-year-olds>, accessed on 13 August 2013.

<sup>3</sup> Ernst Karner 'Tort Law and the Financial Crisis: Basic Questions' (2013) 4(2) *Journal of European Tort Law* 119.

<sup>4</sup> Jonathan Swanepoel, 'Credit rating agencies – soon to face wide-ranging liability?', 30 November 2012, available at <http://www.webberwentzel.com/wwb/content/en/ww/ww-most-popular?oid=44154&sn=Detail-2011&pid=32711>, accessed on 17 July 2013.

<sup>5</sup> [2012] FCA 1200.

<sup>6</sup> Lisa McKenna, 'An uncertain forecast for credit rating agencies: liability for negligent misrepresentation after *Bathurst*' (2012) *Columbia Business Law Review Online*, available at <http://cblr.columbia.edu/archives/12449>, accessed on 18 August 2013.

litigators will be attempting to establish if their own jurisdictions permit the replication of the novel *Bathurst* findings, the ratings agencies will be scrambling to shore up their legal defences to potential exposure and the investment banks will be taking note of the consequences for their own operations, the fate of which has become deeply enmeshed with the ratings agencies.

This paper will show that the legal questions at play here are not merely academic. They have real-world consequences and will continue to do so for some time to come as market participants attempt to understand them and deal with their litigation and compliance risks. In an abstract economic sense, the argument for the appropriate participation of ratings agencies in capital markets should not be underemphasised. In the best case, rating agencies are indirectly responsible for the market's efficient allocation of capital by reducing the asymmetry of information inherent in a lender-borrower relationship.<sup>7</sup> But in the worst case, where they fail in this role, the information they provide is inaccurate, unreliable and contributes to investors allocating capital to debtors who default on their obligations more readily than the terms of their agreements had priced in.<sup>8</sup> This is an obvious problem for any market system that aims to allocate capital efficiently, and of course it is a problem for market participants who rely on ratings to their detriment.

Just how significant is the function that ratings agencies perform in the global financial system? The three largest rating agencies are tremendously powerful and they are defendants with very deep pockets.<sup>9</sup> The 'big three' together own 95% of the ratings market and in 2007 shared total revenues of over \$6 billion.<sup>10</sup> They are

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<sup>7</sup> Nan S. Ellis, Lisa M. Fairchild & Frank D'Souza 'Is imposing liability on credit rating agencies a good idea?: Credit rating agency reform in the aftermath of the global financial crisis' (2012) 17 *Stanford Journal of Law, Business & Finance* 175 at 179.

<sup>8</sup> Ellis, Fairchild & D'Souza op cit note 7 at 179

<sup>9</sup> New York Times columnist Thomas Friedman said in 1996 that 'There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful.' See Roger Lowenstein 'Triple-A failure' *New York Times*, 27 April 2008, available at [http://www.nytimes.com/2008/04/27/magazine/27Credit-t.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2008/04/27/magazine/27Credit-t.html?pagewanted=all&_r=0), accessed on 22 July 2013.

<sup>10</sup> Cyrus Sanati 'Ratings agencies draw fire on capitol hill' *New York Times*, 22 October 2008, available at <http://dealbook.nytimes.com/2008/10/22/rating-agencies-draw-fire-capitol-hill/> accessed on 20 July 2013. It is interesting that while there are over 150 credit rating agencies globally, the so-called "Big 3"—Standard & Poor's Ratings Services, Moody's Investor's Service and Fitch Ratings—together hold more than 95% of the market in a highly oligopolistic system. Each of the Big 3 has an office and operations in South Africa.

also deeply ingrained in society's consciousness, having existed in the United States since the 1840s when they were called mercantile agencies and in the form that we think of them today since the founding by John Moody of the original Moody's in 1909.<sup>11</sup> Given the massive scope of their operations in a modern, interconnected economy, the major ratings agencies face legal exposure in many jurisdictions, including South Africa. This dissertation is an attempt to clarify the circumstances in which a South African court will hold a credit ratings agency liable to the purchaser of a structured credit product for losses caused by their reliance on negligently compiled ratings that are inaccurate.

Chapter 2 begins with an examination of the functions of credit rating agencies on a micro scale and then in the context of a globally integrated financial system. This is necessary because any appreciation of the liability that might attach to their opinions must flow from an understanding of the unique problems that arise because of how they conduct their business. Chapter 3 argues that rating agencies played a central role in the financial crisis (indeed, there is in fact a growing body of evidence that the ratings agencies themselves have made significant admissions in this regard).<sup>12</sup> Chapter 4 provides an overview of the newly promulgated Credit Ratings Services Act.<sup>13</sup> Chapter 5 is an examination of the liability regime envisaged by the Act in respect of rating agencies who cause investors to suffer pure economic losses and an application of how those principles might be applied by a court. Chapter 6 is a comparative perspective on the approaches to rating agency liability in selected common law jurisdictions, specifically Australia, England and the United States, with a special focus on lessons and principles that may be relevant to the South African situation. Chapter 7 contains some general reflections about civil liability as a deterrent against negligence in the context of capital market 'gatekeepers' and the wisdom of a legal system appearing to forsake the fundamental principle of *caveat emptor*. Finally, Chapter 8 contains some tentative conclusions

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<sup>11</sup> Jakob de Haan & Fabian Amtenbrink 'Credit Rating Agencies' (2011) *De Nederlandsche Bank Working Paper No. 278* at 1.

<sup>12</sup> Noemi Blumberg, Joanna Wirth & Nikita Litsoukov 'The liability of credit rating agencies to investors: a review of the current liability regime and recent SEC proposals' 2011 *The Journal of Structured Finance* 34. The authors refer to leaked internal emails that make frank admissions about agencies' incompetence and lack of independence.

<sup>13</sup> No. 24 of 2012.

about what the future may hold for plaintiff investors and rating agency defendants, as well as some recommendations for the application of judicial standards.

## 2. Credit rating agencies as financial intermediaries

What is it that credit ratings agencies do, and why do they do it? In answering these questions it is highly instructive to consider, first, the theoretical arguments for ratings agencies' participation in capital markets and, second, the extent to which the application of those arguments in reality diverges from their theoretical case. Such an analysis reveals that the *de facto* role occupied by ratings agencies is highly determinative of a debtor's success in raising capital, and that certain structural features of their operations give rise to unique problems of independency that are difficult to mitigate.

### 2.1. The economic case for credit rating agencies

In theory, the role of credit rating agencies is simply to facilitate the efficient allocation of credit between lenders and borrowers by increasing the level of transparency in a particular capital market.<sup>14</sup> This is best thought of as a mechanism whereby the overall cost of information to traders of financial products is lowered,<sup>15</sup> the central idea being that rating agencies facilitate a flow of information by analysing all available data and delivering it in digestible quantities much more affordably than if each investor attempted to perform the same level of research on their own.<sup>16</sup>

To see the merit in this, consider a situation in which rating agencies are absent from the financial system.<sup>17</sup> If we assume that investors are risk-averse but profit seeking (that is, they always prefer capital protection and will only permit more risk when it is matched with higher returns), they would need to use their own resources and efforts in assessing debtors before making any investments. There is academic consensus that the investor in such a hypothetical situation would consider

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<sup>14</sup> Andrea Migliocino 'Enhancing the regulation of credit rating agencies, in search of a method' *Centre for financial and management studies: working paper* (July 2012) 61 available at <http://www.cefims.ac.uk/cgi-bin/research.cgi?id=99> accessed on 17 September 2013.

<sup>15</sup> Gregory Husisian 'What standard of care should govern the world's shortest editorials? An analysis of bond rating agency liability' 1990 (75) *Cornell Law Review* 411 415; Ronald Gilson & Reinier Kraakman 'Mechanisms of market efficiency' 70 (1984) *Virginia Law Review* 549 594.

<sup>16</sup> Gilson & Kraakman op cite note 15 at 594.

<sup>17</sup> Husisian op cit note 15 at 417.

the benefit of the necessary research to be too small to justify the significant costs in money and time—returns in a highly complex, diffuse bond market are already always small and investors are often unsophisticated.<sup>18</sup> These high information costs are prohibitive for debtors wishing to raise capital too, because it requires that they increase their issuing costs by embarking on marketing projects to encourage investors to subscribe for their debt securities.<sup>19</sup> Thus, high information costs have negative implications for the system as a whole: debt issuers are forced to increase the costs of their operations and potential investors are prone to stay in the least risky investments and thereby stifle the optimum allocation of the market's savings.

In light of this, the role of ratings agencies is to work to reduce these information costs and increase efficiency in capital markets. They do this in practice by employing experts in mathematical and statistical modelling who publish opinions about a debtor's credit risk (generally or with regard to a particular financial instrument), that is, how likely it is that a debtor will repay its creditors.<sup>20</sup> The entire market benefits from the economies of scale generated by the centralisation of research resources in the agencies themselves.<sup>21</sup> Potential creditors who come into in possession of a debtor's credit rating are better equipped to assess the risk of lending to that debtor and what the appropriate commercial terms of finance should be, the rating agencies target their analyses optimally and the market adjusts prices quickly as a consequence of the rapid distribution of information.<sup>22</sup>

## *2.2. How opinions are provided*

Credit rating agencies express their ratings of the credit risk of a debtor by means of a symbolic representation, almost always as a score on an alphabetical scale of letters and symbols. The categories used by the dominant market participants are shown in Table 1 below.<sup>23</sup> A scoring on this scale is supposed to provide a shortcut in the evaluation of a financial instrument's credit risk such that investors can be confident that a debtor or debt security that receives a particular rating will share the

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<sup>18</sup> Husisian op cit note 15 at 418.

<sup>19</sup> Husisian op cit note 15 at 419.

<sup>20</sup> Rachel Jones 'The need for a negligence standard of care for credit rating agencies' (2010) 1 *William & Mary Business Law Review* 201 at 202.

<sup>21</sup> Arthur R. Pinto 'Control and responsibility of credit rating agencies in the United States' (2006) 54 *American Journal of Comparative Law* at 341; Husisian op cit note 15 at 421.

<sup>22</sup> Husisian op cit note 15 at 421.

<sup>23</sup> De Haan & Amtenbrink op cit note 15 at 6.

characteristics that are ordinarily assigned to a particular rating.<sup>24</sup> Despite the fact that the rating agencies almost always try to divest investors of the notion that ratings are buy/sell/hold recommendations, it is generally accepted that ratings are a critical component in ordinary investors' strategies. This culture of reliance is embedded in the financial system to the extent that many institutional funds are bound by strict investment rules that outright prevent them from buying debt below a certain rating.<sup>25</sup> It is important to point out that rating agencies do not claim to perform an independent verification of the data they work with. In this way, they purport to distinguish their work from that of auditors.<sup>26</sup>

<b>Interpretation</b>	<b>Fitch and S&amp;P</b>	<b>Moody's</b>
Highest quality	AAA	Aaa
High quality	AA+	Aa1
	AA	Aa2
	AA-	Aa3
Strong payment capacity	A+	A1
	A	A2
	A-	A3
Adequate payment capacity	BBB+	Baa1
	BBB	Baa2
	BBB-	Baa3
Likely to fulfil obligations, ongoing uncertainty	BB+	Ba1
	BB	Ba2
	BB-	Ba3
High risk obligations	B+	B1
	B	B2
	B-	B3
Vulnerable to default	CCC+	Caa1
	CCC	Caa2
	CCC-	Caa3
Near or in bankruptcy or default	CC	Ca
	C	C
	D	D

**Table 1**

<sup>24</sup> Alessandro Scarso 'The liability of credit rating agencies in comparative perspective' (2013) 4(2) *Journal of European Tort Law* 163 at 164.

<sup>25</sup> Husisian op cit note 15 at 424.

<sup>26</sup> Whether they are successful in doing so is a matter of some debate. See e.g. Blumberg op cit note 12 at 34.

### 2.3. *The gatekeeping function of ratings agencies*

In spite of the rating agencies' express statements to the contrary, their function in the capital markets has been described as of a similar nature to accountants and certain other financial professionals because of the 'protection' they supposedly provide to public investors.<sup>27</sup> Just as auditors certify that a firm's accounting records accurately reflect the financial affairs of a business, it is indisputable that credit rating agencies provide a kind of certification with regards to debtor's credit quality,<sup>28</sup> where a credit rating is perceived to provide an official 'seal of approval'.<sup>29</sup> Thus, there is an implicit 'bond of trust' between investors and credit rating agencies,<sup>30</sup> and credit rating agencies can thus be described as fulfilling a 'gatekeeping' function by contributing to the market's integrity.<sup>31</sup> It is easy to understand the appropriateness of this metaphor: if enough ratings agencies withhold a particular certification desired in respect of a debtor or its securities, the proverbial 'gate is shut' and the debtor's access to the capital markets is completely cut off.<sup>32</sup>

As suggested above, the agencies themselves would point out that while there may be some similarities in this regard, they "do not audit companies, offer advice, or recommend certain products".<sup>33</sup> At most, they would argue, they give opinions.<sup>34</sup> That being said, the market treats them differently.<sup>35</sup> Whether they desire the burden or not, it is inherent in the institutional structure of modern capital markets that credit rating agencies have been assigned the role of risk assessors.<sup>36</sup> This has led to a situation where rating agencies occupy a 'quasi-public' position because their assessments impact directly on the interest rates that borrower companies and governments must pay.<sup>37</sup> As one author argues,<sup>38</sup> the agencies themselves have only

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<sup>27</sup> Ellis, Fairchild & D'Souza op cit note 7 at 177.

<sup>28</sup> Ibid.

<sup>29</sup> Tobias Johannson 'Regulating credit rating agencies: the issue of conflicts of interest in the rating of structured credit products' (2010) 12(1) *Journal of Banking Regulation* 1 at 2.

<sup>30</sup> Johannson op cite note 29 at 2.

<sup>31</sup> Ellis, Fairchild & D'Souza op cit note 7 at 176.

<sup>32</sup> Sung Hui Kim 'Gatekeepers inside and out' (2008) 21 *Georgetown Journal of Legal Ethics* 411 at 415.

<sup>33</sup> Jones op cit note 20 at 202.

<sup>34</sup> Ibid.

<sup>35</sup> Dieter Kerwer, 'Holding global regulators accountable: the case of credit rating agencies' (2005) 18(3) *Governance: an international journal of policy, administration and institutions* 453 at 470.

<sup>36</sup> Kerwer op cit note 35 at 470.

<sup>37</sup> Husisian op cite note 15 at 424. Hugh Sherwood 'How corporate and municipal debt is rated: an inside at Standard and Poor's rating system' 32(5) (1977) *The Journal of Finance* 1828.

partially accepted this role, leading to a stark divergence of views with regards to how much liability their opinions should attract.<sup>39</sup>



Figure 2

#### 2.4. Structural problems associated with ratings agencies

The global financial crisis demonstrated the mission-critical nature of properly functioning capital markets in the modern global economy.<sup>40</sup> It has been compellingly argued that there are three instruments universally necessary for the maintenance of properly functioning capital markets: (a) avoiding conflicts of interest, (b) duties of disclosure and (c) adequate supervision.<sup>41</sup> A deficiency in any of these components can have deleterious effects on the integrity of a capital market and contribute to its operating sub-optimally. In the sub-section that follows I will canvass each of these elements more extensively to demonstrate the extent to which the rating agencies *as capital markets participants* are mired in unique, structural problems.<sup>42</sup>

<sup>38</sup> Sherwood op cit note 37 at 1828.

<sup>39</sup> Cf. Harry Edwards, 'CRA 3 and the liability of rating agencies: inconsistent messages from the regulation on credit rating agencies in Europe' 2013 *Law and Financial Markets Review* 186 at 188 (opposed to liability) and Ellis op cit note 7 (in favour of liability).

<sup>40</sup> See Chapter 3 infra.

<sup>41</sup> Thomas Möllers 'Regulating credit rating agencies – the new United States and European Union law – important steps or much ado about nothing?' (2009) 4 *Tydskrif vir die Suid Afrikaanse Reg* 674 at 677.

<sup>42</sup> Ibid at 677-678.

### 2.4.1. *Conflicts of interest*

The conflict of interest problem is one that is very familiar to all legal systems. The classic response to this problem is the carving out of a framework of fiduciary duties with remedies for their breach.<sup>43</sup> Certain categories are well established already: directors, trustees, agents and partners owe fiduciary duties to companies, beneficiaries, principals and other partners, respectively, by virtue of the position they occupy in relation to the affairs of that other legal person. The principle that governs this classic corporate governance problem is well founded in our law. Fiduciaries stand in positions of significant power with regards to their principal's affairs, thus they must always act in the best interests of their principal.<sup>44</sup> This is an absolute duty, one manifestation of which is that fiduciaries must seek to avoid conflicts between their interests and those of their principals. What is clear from the authorities, however, is that the rules governing conflicts of interest are not isolated to particular types of relationships, their extension from trust law to company law being ample evidence of this. We are therefore in familiar legal territory when looking at conflicts of interest in novel situations.

In the context of ratings agencies, the most obvious and important conflict of interest arises in the case where a debt issuer contracts with a rating agency to rate one of its securities that it is intending to market for subscription in accordance with the 'issuer pays' model.<sup>45</sup> This model is a relatively recent development but is now the market standard.<sup>46</sup> Before this model became dominant, ratings were issued by agencies to, and for the benefit of, potential subscribers of debt securities.<sup>47</sup> However, the capital markets evolved and investors increasingly demanded that securities issuers retain at least one rating to be eligible for subscription.<sup>48</sup>

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<sup>43</sup> Lu Zhang & Yanyan Xing, 'Brief analysis on conflicts of interest of credit rating agencies' (2012) 8(4) *Canadian Social Science* 144 at 145.

<sup>44</sup> This has been the position in common law jurisdictions since the seminal decision of Lord King in the trust law case *Keech v Sandford* [1726] EWHC Ch J76.

<sup>45</sup> Frank Partnoy 'How and why credit rating agencies are not like other gatekeepers' in Yasuyuki Fuchita, Robert E. Litan, eds *Financial gatekeepers: can they protect investors?* 1ed 2006; John Coffee 'The mortgage meltdown and gatekeeper failure' (2007) *New York Law Journal* 2.

<sup>46</sup> Claire Hill 'Why did rating agencies do such a bad job rating subprime securities?' 2010 (71) *University of Pittsburgh Law Review* 585 at 595.

<sup>47</sup> Hill op cite note 46 at 595.

<sup>48</sup> Marilyn Cane, Adam Shamir & Tomas Jodar 'Below investment grade and above the law: a past, present, and future look at the accountability of credit rating agencies' (2011) *Fordham Journal of Corporate and Financial Law* 5.

Compounding this were problems associated with preventing subscribers from disseminating the ratings to non-subscribers and thereby making the ratings public (and therefore free) information.<sup>49</sup> Whatever its provenance, the ‘issuer pays’ business model has firmly taken root and appears to be here to stay. It is in this model that there is clear a divergence of interests. On the one hand, the rating agency is under a professional (and often contractual) duty to rate the particular debt security accurately, even if that means giving the debt securities issuer, who is also a client, a lower rating than they might have desired. But, on the other hand, the rating agency is also incentivised by commercial reasons to keep the client happy so that they will bring back business in the future.<sup>50</sup> This gives rise to an associated problem of ‘forum shopping’, where because the debt securities issuer is required to pay for its ratings, generally it will solicit several ‘quotations’ from ratings agencies and select the ‘highest of the lowest’, with negligible regard to accuracy, its focus rather being trained on price and the perceived value (or positivity of rating) only.<sup>51</sup>

The situation just described is the conflict of interest problem in the context of rating agencies in its simplest form. However, several realities of the modern debt capital market compound it and deeply enmesh associated problems. First, as suggested above, particular classes of investors are often bound to purchase only ‘investment grade’ products for their portfolios, for example large, institutional pension funds and insurers. These investors are where, by far, the bulk of the market’s capital lies, and debt securities issuers are perpetually engaged in competition for their funds. The consequence of a high concentration of capital being subject to stringent investment rules is that market participants are incentivised, and often required, to only buy and only market securities that are rated as being investment grade.

Second, structured finance products are created and issued by only a handful of investment banks that pay fees to rating agencies to rate them.<sup>52</sup> The proportion of

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<sup>49</sup> Timothy Lynch ‘Deeply and persistently conflicted: credit rating agencies in the current regulatory environment’ 59 (2009) *Case Western Reserve Law Review* 227 at 239.

<sup>50</sup> Lisbeth Freeman ‘Who’s guarding the gate? Credit-rating agency liability as “control person” in the subprime credit crisis’ (2009) 33 *Vermont Law Review* 585 at 600.

<sup>51</sup> Hill *op cit* note 46 at 585.

<sup>52</sup> Joseph Mason & Joshua Rosner ‘Where did the risk go? How misapplied bond ratings cause mortgage backed securities and collateralized debt obligation market disruptions’ (unpublished draft),

rating agencies' income attributable to structured finance products has increased significantly in recent times and this has resulted in a situation where, in the eyes of the ratings agencies, there is a disproportionately high concentration of earnings capacity in very few investment bank clients, increasing the banks' perceived and real influence over the ratings agencies.<sup>53</sup> Third, the rise in popularity of structured finance products has also seen a rise in the role played by ratings agencies in the actual composition and design of those products. In these situations the rating agency adopts a quasi advisory/consultancy role, with the attendant danger that they will be hesitant to act impartially in their capacity as an independent rating agency should circumstances change for the worse. It is certainly not obvious, at least, that they would act against their earlier advices to the contrary without any hesitation.<sup>54</sup>

It is submitted that these factors suggest that the independence of rating agencies is perhaps a something of an ideal. As this paper will show, the extent to which a particular ratings agency defendant is alive to these problems and attempts to minimise their impact is almost certainly something that a court will take into account when making a determination as to the wrongfulness element of a delictual claim by a disappointed investor.<sup>55</sup>

#### *2.4.2. Disclosure of methodologies*

A cornerstone of capital market efficiency is that participants are all operating within the bounds of the same informational constraints. This is so in order to enable the price mechanism to most accurately reflect disagreements on value.<sup>56</sup> This may seem counterintuitive, but consider, for example, that for every trade that is executed on the Johannesburg Stock Exchange, there is an agreement on the price of the security to be traded but a disagreement on value. Both sides of any transaction believe they are getting the better deal. If the information is asymmetrical, however, one side of a transaction has an advantage that enables it to profit at the expense of the counterparty. Governments view this situation as market abuse, giving rise in nearly

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May 2007, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1027475](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027475), accessed 15 October 2013.

<sup>53</sup> Coffee op cit note 43.

<sup>54</sup> Coffee op cit note 43.

<sup>55</sup> See 5.2.3 *infra*.

<sup>56</sup> Möllers op cite note 41 at 677.

all jurisdictions to laws that try to proscribe the efforts of “insiders” to trade with the benefit of such one-sided information.<sup>57</sup>

This is relevant in our context because the ratings agencies only sometimes disclose their precise modelling methodologies.<sup>58</sup> Often they provide only a mere summary rationale of the analysis employed, leaving much to speculation.<sup>59</sup> This partial disclosure of ratings methodologies, for business reasons or otherwise, brings with it obvious problems for capital market efficiency since any hindrance to relevant information being factored into a market price obscures the true value of an investment.<sup>60</sup>

#### 2.4.3. *Adequacy of supervision*

Ratings agencies, up until recently, were subject to no other regulation than the maintenance of their own reputations in accordance with the reputational capital theory.<sup>61</sup> Thus, regulatory frameworks under which the ratings agencies received proper supervision by public law authorities simply never existed.<sup>62</sup> It has been argued that the stakes are simply too high in the context of the maintenance of stable and functional capital markets for there to not be any preventative public law regulation and supervision of ratings agencies,<sup>63</sup> the idea being that deterrent civil law remedies, like claims for damages in cases of negligence, are insufficient safeguards. As will be discussed later in this paper, the International Organisation of Securities Commissions (IOSCO) is currently taking steps to ensure that member states adhere to particular standards of regulatory supervision.<sup>64</sup>

#### 2.5. *Regulation—from within or without?*

The economic function that credit rating agencies perform is clearly important, and as academics have rightly pointed out, we would justifiably assume that the activities

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<sup>57</sup> For the recently revised South African position on insider trading see the Financial Markets Act 19 of 2012.

<sup>58</sup> Lynch op cit note 49 at 238.

<sup>59</sup> Cane, Shamir & Jodar op cit note 48 at 5.

<sup>60</sup> Möllers op cite note 41 at 677; Eugene Fama ‘Efficient capital markets: a review of theory and empirical work’ (1970) *Journal of Finance* at 83.

<sup>61</sup> See 2.5 infra.

<sup>62</sup> Möllers op cit note 41.

<sup>63</sup> Möllers op cite note 41 at 678; Jackson & Roe ‘Public enforcement of securities laws: resource-based evidence’ *Harvard Public Law Working Paper no 08-28* (2009), available at <http://ssrn.com/abstract1000086>, accessed on 10 August 2013.

<sup>64</sup> See 4.1 infra.

of ratings agencies would be highly regulated, as it is in the case of the accounting profession.<sup>65</sup> But until very recently, credit rating agencies around the world were largely left to their own devices, the idea being that credit rating agencies are commercial enterprises themselves and the need to maintain their good reputation would serve as the ultimate regulator of their activities.<sup>66</sup> This view suggests that there is an internal market mechanism inherent in the economics of a rating agency as a profit-seeking business that incentivises it to guard and maintain its ‘reputational capital’, thereby ensuring that it will always act in the best interests of market participants.<sup>67</sup> The so-called ‘reputational capital theory’ therefore holds that each rating agency is motivated by reason of profit to ensure the provision of accurate ratings. If they provide inaccurate ratings, debtors who contract them for their services and investors who rely on their ratings will lose trust in them and this will result in an undesirable loss of business.<sup>68</sup> Accordingly, reputational capital theory says that this market mechanism should provide a compelling motivation for ratings agencies to resist any conflict of interest pressures and to perform thorough due diligences and conservative risk analyses.<sup>69</sup>

Despite the logical appeal of reputational capital theory, in practice it appears to have been an insufficient safeguard against damaging negligence, particularly in light of the fallout from the financial crisis.<sup>70</sup> It has been argued that four main reasons are responsible for the failure of reputational capital theory to properly regulate the ratings industry.<sup>71</sup> First, in recent years there has been an embedded culture of regulatory dependence on ratings agencies, whereby institutional investors were relying on ratings not for accuracy but in a kind of ‘box ticking’ exercise for compliance reasons.<sup>72</sup> The unintended but perverse effect of this was to diminish the value of rating agencies as informational intermediaries and to guarantee demand for their ratings services, sometimes in spite of their inaccuracy. Second, there is a

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<sup>65</sup> Ellis, Fairchild & D’Souza op cit note 7 at 180.

<sup>66</sup> Ibid.

<sup>67</sup> Ellis, Fairchild & D’Souza op cit note 7 at 180 at 211; Husisian op cit note 15 at 425.

<sup>68</sup> Kia Dennis ‘The ratings game: explaining rating agency failures in the build up to the financial crisis’ 63 (2009) *University of Miami Law Review* 1111 1130; Ellis, Fairchild & D’Souza op cit note 7 at 212.

<sup>69</sup> Ellis, Fairchild & D’Souza op cit note 7 at 212.

<sup>70</sup> Kim op cit note 26 at 424; Ellis, Fairchild & D’Souza op cit note 7 at 212.

<sup>71</sup> Ellis, Fairchild & D’Souza op cit note 7 at 214.

<sup>72</sup> Ellis, Fairchild & D’Souza op cit note 7 at 214.

misalignment in the short-term payoff associated with providing a rapid but inaccurate rating, because reputational damage accrues over a much longer time frame.<sup>73</sup> Third, the opacity of the structured credit market and the speed with which entirely novel classes of product are developed mean that it is very hard to gauge *ex ante* what might constitute inaccuracy in a rating, from anyone's perspective (expert or not).<sup>74</sup> Finally, given the tendency for rating agencies to be involved in both the rating of debt and increasingly the composition and creation of novel structured finance products in a 'consulting' role with their clients, it is quite clear that there are in reality multiple reputations at stake: rating agencies want to be seen as both prudent and accurate in their monitoring function, but also innovative, inventive and creative in their advisory roles.<sup>75</sup>



Figure 3

<sup>73</sup> John Crawford 'Hitting the sweet spot by accident: how recent lower court cases help realign incentives in the credit rating industry' 42 (2009) *Connecticut Law Review* 13 at 17.

<sup>74</sup> Frank Partnoy 'Barbarians at the gatekeepers? A proposal for a modified strict liability regime' 79 (2001) *Washington University Law Quarterly* 491 at 509.

<sup>75</sup> John Coffee 'What went wrong? A tragedy in three acts' 6 (2009) *University of St Thomas Law Journal* 403 at 406; Johansson op cit note 29 at 5.

### 3. How important were rating agencies in the 2007/8 financial crisis?

#### 3.1. *The financial crisis as a housing crisis*

The 2008 financial crisis was doubtless the outcome of myriad compounding factors,<sup>76</sup> many of which have received extensive academic attention.<sup>77</sup> The crisis had, and continues to have, devastating economic consequences for a large number of countries, firms and people.<sup>78</sup> There is consensus that the roots of the crisis can be traced to a culture in the United States of commercial banks lending to borrowers who were not creditworthy (hence the term “sub-prime”).<sup>79</sup> Banks were lending to sub-prime borrowers because interest rates were very low and debtors could generally be expected to be able to meet unusually relaxed repayment obligations. In fact, it was not uncommon for United States banks to be so lax in their credit checks that mortgages were in some instances even granted to ‘NINJAS’ (persons with No Income, No Job or Assets).<sup>80</sup> Thus, the financial crisis was arguably at heart a housing crisis.<sup>81</sup> Buyers were purchasing homes they could ill-afford because finance was so cheap. The increased supply of money led to a higher demand for real estate and a property boom in the years 2000 – 2006.<sup>82</sup> In response to this investment and expenditure boom the Federal Reserve (the United States’ central bank) began a process of raising interest rates in a bid to decelerate bank borrowing and spending.<sup>83</sup> This is what eventually caused the housing market bubble to burst in 2007.<sup>84</sup>

#### 3.2. *Securitisation*

In the lead-in to the housing bubble bursting, many of the mortgages used to finance property transactions were extensively ‘securitised’ by investment banks.<sup>85</sup> ‘Securitisation’ is nowadays a common market practice. It is best understood as a process of converting assets into new products (asset backed securities (ABSs)) that

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<sup>76</sup> AP Faure ‘Fundamentals of the Financial System’ in Karin van Wyk, Ziets Botha & Ingrid Goodspeed (eds) *Understanding South African Financial Markets* 4 ed 2012 1 at 32.

<sup>77</sup> Möllers op cit note 41 at 674.

<sup>78</sup> Faure op cit note 76 at 34.

<sup>79</sup> Freeman op cit note 50 at 586.

<sup>80</sup> Möllers op cit note 41 at 674; Kurt Eggert ‘The great collapse: how securitization caused the subprime meltdown’ (2009) 41 *Connecticut Law Review* 1257 at 1286.

<sup>81</sup> Ellis, Fairchild & D’Souza op cit note 7 at 192; Eamonn K. Moran ‘Wall Street meets main street: understanding the financial crisis’ (2009) 13 *North Carolina Banking Institute Journal* 5 at 42.

<sup>82</sup> Ellis, Fairchild & D’Souza op cit note 7 at 193; Moran op cit note 81 at 20.

<sup>83</sup> Faure op cit note 76 at 33.

<sup>84</sup> Ellis, Fairchild & D’Souza op cit note 7 at 197.

<sup>85</sup> Ellis, Fairchild & D’Souza op cit note 7 at 193.

can be further traded. In general this process has three stages:<sup>86</sup> (i) the bringing together of a group of income-producing assets which share the same characteristics (usually debts on which interest is received), (ii) the sale of those assets by the original holder (the creditor) to an insolvency-remote “special purpose vehicle” (SPV), and (iii) the issue by the SPV of marketable securities (usually debt) to finance the purchase of the assets.<sup>87</sup> In the context of mortgages on immovable property, loan originators sold individual mortgages into a pool of “mortgage-backed securities” (MBSs) or “collateralised debt obligations” (CDOs), housed in SPVs that issued debt securities with the mortgages serving as security.<sup>88</sup> The benefits to creditors (for example, home loan originators) in this process are obvious. Instead of having to wait 20 or 30 years to be paid back by debtors, banks could have their capital stores replenished at a much quicker rate and thus be in position to write new loans sooner.<sup>89</sup> This “repackaging” of pooled loans is what gives rise to their label as a type of “structured finance product”.

In the years leading up to the financial crisis these particular kinds of structured finance products were sold to investors all over the world.<sup>90</sup> When the market disruption took hold in 2007/2008 the default experience on these types of debt securities was so severe that it affected even AAA-rated structured finance products that were held by investors who were highly geographically dispersed.<sup>91</sup> Securitisation was thus critical for ensuring that the financial crisis’s contagion spread very much more widely than the market from which it originated, affecting exponentially more people and firms, and, as importantly, ensuring that investors’ understanding of the default risks of the securities they were acquiring was obscured.

### *3.3. Rating agencies and the rise of structured finance products*

Rating agencies are fundamentally involved in the rating, marketing (and, as suggested above, oftentimes the creation) of structured finance products. However, in theory, their role is to act as independent third parties who are consulted in order

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<sup>86</sup> These stages can be, and indeed very often are, significantly more complex, but the definition provided captures the general essence. See Ellis, Fairchild & D’Souza op cit note 7 at 193.

<sup>87</sup> Natania Locke *Aspects of traditional securitisation in South African law* (doctoral thesis, University of South Africa 2008) 30.

<sup>88</sup> Ellis, Fairchild & D’Souza op cit note 7 at 193.

<sup>89</sup> Lowenstein op cit note 9.

<sup>90</sup> Möllers op cit note 41 at 675.

<sup>91</sup> Faure op cit note 76 at 34.

to balance informational differences that arise between lenders and borrowers, according to standardised categorisations of risk of default (see Table 1 above).<sup>92</sup> As explained above, these categorisations are assigned to debtors and/or their structured products using highly complex mathematical and statistical models based on the historical performance of a certain category of assets.<sup>93</sup> In the special case of structured finance products, the agencies ordinarily rate the credit risk associated with a particular class of CDOs housed in an SPV, which ratings are in turn extensively utilised by investors when making their capital allocation decisions.<sup>94</sup> There is academic consensus that in the period before the financial crisis credit rating agencies were overly optimistic in their assessment of CDO credit risk arising from structured finance products backed by sub-prime mortgages.<sup>95</sup> This was as a consequence of *inter alia* the inclusion of problematic assumptions in statistical models, the structurally problematic role occupied by rating agencies, and the unique pressures on ratings agency staff both caused and exacerbated by the rapid rise in securitisation in the run up to the financial crisis.<sup>96</sup>

That being said, the most important consequence of credit rating agencies giving overly generous ratings was that institutional investors (who are bound by very rigid investment rules) were acquiring structured finance products that were inherently very risky on the basis of their being rated as “investment grade”.<sup>97</sup> In the run-in to the crisis it was not uncommon for CDOs comprising the riskiest sub-prime assets to be repackaged by investment banks in such a way that eighty per cent of a particular structure could still be assigned an AAA rating,<sup>98</sup> signifying the highest quality of debtor.

#### 3.4. *The bubble bursts*

Had the ratings agencies carried out their work with the requisite due diligence, proper analysis of these structured finance products could have, and should have,

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<sup>92</sup> See 2.2 *infra*.

<sup>93</sup> Ellis, Fairchild & D’Souza *op cit* note 7 at 200.

<sup>94</sup> Natania Locke, ‘The role of rating agencies in the course of a securitization scheme’ (2008) *De Jure* 545 at 550.

<sup>95</sup> Ellis, Fairchild & D’Souza *op cit* note 7 at 196.

<sup>96</sup> Richard E. Mendales ‘Collateralized explosive devices: why securities regulation failed to prevent the CDO meltdown, and how to fix it’ (2009) 5 *University of Illinois Law Review* 1359 at 1380.

<sup>97</sup> Möllers *op cit* note 41 at 676.

<sup>98</sup> Ellis, Fairchild & D’Souza *op cit* note 7 at 196; Möllers *op cit* note 41 at 676.

limited the fallout when the bubble burst.<sup>99</sup> But as suggested above, this was not the case. When the housing bubble eventually burst in 2007, the so-called chickens came home to roost for holders of mortgage-backed securities who saw their payments and capital evaporate as a consequence of the widespread defaults, often completely.<sup>100</sup> Some institutions that were particularly exposed to these securities, like Lehman Brothers and Bear Sterns, and latterly Northern Rock in the UK, collapsed as consequence of the plummeting value of their assets. Others, in particular those that were considered to be ‘systemically important financial institutions’ (SIFIs), were bailed out by their governments.<sup>101</sup>

Despite overwhelming evidence of the increasing number of subprime borrowers defaulting and the concomitant depression in the strength of the MBSs, credit rating agencies have been castigated because they initially did not revise their ratings downward, even when the extent of the financial crisis became clear.<sup>102</sup> It was only after significant public pressure that the rating agencies relented and downgraded many of their overly optimistic ratings, in some cases by more than five notches in one leap.<sup>103</sup> If this situation was confined to the US alone, that would have been the end of the matter and the financial crisis that ensued when the central bank increased interest rates would have been a crisis for the US financial markets only. However, as explained above, massive advances in communications and technology have meant that global capital markets in the modern era are highly interconnected and interdependent, thus the on-selling of these MBSs to investors all over the world guaranteed that the financial crisis was truly global.<sup>104</sup> These “toxic assets” are now firmly rooted in the balance sheets of financial institutions around the world, and in the case where a financial institution survived the crisis, they are likely unable to be traded away at all.<sup>105</sup>

It is this situation that gave rise to what has been popularly described as the global “credit crunch”, where institutional investors were forced to restrict their

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<sup>99</sup> Möllers op cit note 41 at 677.

<sup>100</sup> Lowenstein op cit note 9.

<sup>101</sup> Faure op cit note 76 at 34.

<sup>102</sup> Möllers op cit note 41 at 676.

<sup>103</sup> For example, Fitch downgraded GMAC Financial Services from BB- to CCC in November 2008, an unprecedented jump. See e.g. Möllers op cit note 41 at 676.

<sup>104</sup> Möllers op cit note 41 at 676.

<sup>105</sup> Möllers op cit note 41 at 675.

lending activities and seek additional capital in order to meet regulatory capital and liquidity requirements.<sup>106</sup> The effect of this was self-reinforcing and in a very short space of time the availability of credit effectively dried up. This evaporation of capital from the capital markets guaranteed an unprecedented global economic slowdown, which was certainly borne out in reality.

### *3.5. The impact of the financial crisis on South Africa*

In spite of the pervasiveness of the global financial crisis, South Africa's exposure was thankfully less severe than a large number of other countries.<sup>107</sup> National Treasury has attributed this to five main factors: (i) sound financial regulation that did not rest on the 'light touch' principle favoured by other states, (ii) limited foreign asset exposure owing to strict foreign exchange controls, (iii) appropriate bank risk management, (iv) ring-fencing of balance sheets of foreign banks operating locally, and (v) high levels of disclosure and corporate governance under the JSE's listing requirements.<sup>108</sup> While these factors certainly helped to limit the extent of the crisis in South Africa, our economy remains small and open, and thus highly susceptible to external shocks.<sup>109</sup> Consequently, the government has prioritised strengthening of the financial regulatory system in order to prevent a 'body blow' from similar events in the future.

Proposals that are to be implemented include, firstly, moves to change to a macroprudential approach to regulation that analyses the interconnected financial system in its entirety (as opposed to a microscopic focus on individual firms and institutions), and, secondly, establishing a 'twin peaks' regulatory framework that separates prudential regulation on the one hand (soundness and solvency of financial institutions, to be monitored by the Reserve Bank), from market conduct regulation (consumer welfare, monitored by the Financial Services Board (FSB)) on the

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<sup>106</sup> Justin Lahart et al 'World economy shows new strain; European output shrinks; US inflation jumps; fresh worries in developing nations' (2008) *Wall Street Journal* available at <http://online.wsj.com/news/articles/SB121874575081241907>, accessed on 15 October 2013.

<sup>107</sup> Karin van Wyk 'Regulation of the financial markets' in van Wyk, Botha & Goodspeed op cit note 76 at 122.

<sup>108</sup> National Treasury discussion document 'A safer financial sector to serve South Africa better' (2011) available at <http://www.oecd.org/site/iops/research/48464023.pdf> accessed on 15 August 2013.

<sup>109</sup> Van Wyk op cit note 107 at 123.

other.<sup>110</sup> This change will take hold in parallel with other moves to expand the boundary of financial regulation to include activity in the financial markets that was previously unregulated, especially the market for over-the-counter (OTC) derivatives,<sup>111</sup> and, most importantly for present purposes, the activities of credit rating agencies.<sup>112</sup>

### *3.6. Ratings agencies and financial system reform*

After the fallout from global financial crisis had begun to settle, the Group of 20 Finance Ministers and Central Bank Governors (the G-20) met on multiple occasions to discuss and ensure a uniform, cohesive response to prevent a similar economic meltdown from occurring again. The major goals of this co-ordinated response were to improve transparency, mitigate systemic risk and put in place appropriate market abuse prevention measures.<sup>113</sup>

With regards to rating agencies in particular, the sixth standing committee of IOSCO published a set of principles for guidance of members as early as 2003, the idea being that compliance would serve the three broader “core objectives of securities regulations” that were identified by IOSCO, specifically, “improving investor protection, ensuring that securities markets are fair, efficient and transparent and reducing systemic risk”.<sup>114</sup> With these objectives in mind, IOSCO settled on four rating agency principles. These principles are “(i) quality and integrity in the rating process, (ii) independence and managing conflicts of interest, (iii) transparency and timeliness of ratings disclosure, and (iv) maintenance of confidential information”.<sup>115</sup> These principles were what later formed the basis of the IOSCO Code of Conduct.<sup>116</sup> The Code of Conduct in relation to rating agencies is non-compulsory, the idea being that voluntary compliance is preferred. However, this ‘soft’ enforcement mechanism means that rating agencies are requested to disclose whether they comply with the standards, and if they do not, they are

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<sup>110</sup> Ibid.

<sup>111</sup> See e.g. the Financial Markets Act No 19 of 2012.

<sup>112</sup> See chapter 4 *infra*.

<sup>113</sup> Van Wyk *op cite* note 107 at 111.

<sup>114</sup> See Technical Committee of the Internationalisation of Securities Commissions ‘Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of the Credit Rating Process and Procedures to Manage Conflicts of Interest Consultation Report’ available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD380.pdf>, accessed on 19 August 2013.

<sup>115</sup> Ibid.

<sup>116</sup> Ibid.

requested to explain where they deviate and why.<sup>117</sup> This is very similar in practice to the regime that governs corporate governance compliance in South Africa under King III. Professed and actual compliance brings with it the gains in perceived legitimacy that one might expect, while the converse is also true for non-compliance.



Figure 4

## 4. The Credit Ratings Services Act

### 4.1. Introduction

South Africa is a member state of IOSCO and it is therefore required to adopt at a national level its principles and standards, including in relation to the regulation of credit rating agencies.<sup>118</sup> This obligation, together with a G-20 commitment to establish a globally consistent regulatory framework and similar moves by other jurisdictions is what motivated the legislature to deliberate on and eventually pass the Credit Rating Services Act<sup>119</sup> (hereafter ‘the Act’). The Act was assented to on 9 January 2013 and its date of commencement was 15 April 2013. It is accordingly a new piece of legislation that has not yet been litigated in our courts nor received much in the way of academic attention. The Act regulates the activities of credit rating agencies in South Africa and purports to do so with reference to the objects that are expressly stated in Section 2:<sup>120</sup>

“**2. Objects of Act.**—The objects of this Act are to—

<sup>117</sup> Ibid.

<sup>118</sup> Parliamentary Monitoring Group ‘Meeting report on Credit Ratings Services Bill [B8-2012] and Financial Markets Bill [B12-2012] National Treasury briefing’ available at <http://www.pmg.org.za/report/20121121-credit-rating-services-bill-b8%E2%80%93932012-proposed-section-75-and-financial> accessed on 20 July 2013.

<sup>119</sup> No. 24 of 2012.

<sup>120</sup> Preamble to the Act.

- (a) ensure responsible and accountable credit rating agencies
- (b) protect the integrity, transparency and reliability of the credit rating process and credit ratings;
- (c) improve investor protection;
- (d) improve the fairness, efficiency and transparency of financial markets; and
- (e) reduce systemic risk.”

Given the preceding discussion in chapters 2 and 3 about the role of credit rating agencies in the financial markets, the fact that the Act expressly recognises the need to serve these objectives is laudable. That said, as with the Companies Act,<sup>121</sup> the wisdom of including the Act’s very broad aims within the Act itself (as opposed to the preamble or a policy document) is not immediately clear.<sup>122</sup>

The Act comprises eight chapters. Chapter 1 contains the relevant definitions, objects and application of the Act. Chapter 2 deals with the registration of credit rating agencies and sets out the circumstances under which the registration of credit rating agencies can be suspended or cancelled. Chapter 3 is concerned with the duties of credit rating agencies, the methods to be adopted by credit rating agencies when ratings are issued and requirements in relation to those ratings. Chapter 3 further obliges credit rating agencies to adopt a code of conduct, acquire the registrar’s approval before outsourcing,<sup>123</sup> make certain disclosures, maintain records, publish annual reports, establish and maintain independent compliance functions and observe specific accounting and auditing requirements. Chapter 4 lists the requirements for the endorsement by credit rating agencies of external credit ratings.<sup>124</sup> Chapter 5 sets out the provisions pertaining to the liability and

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<sup>121</sup> No. 71 of 2008.

<sup>122</sup> Farouk Cassim ‘Introduction to the new Companies Act: general overview of the Act’ in Farouk Cassim et al *Contemporary Company Law* 1 ed 2011 1 at 4.

<sup>123</sup> ‘Outsource’ is defined in s 1 of the Act to mean “the contracting out of a function to an external provider in a manner that may materially impair the quality of the internal control of the registered credit rating agency and the ability of the registrar to supervise the compliance of the registered credit rating agency with its obligations under this Act”.

<sup>124</sup> S 1 of the Act defines “external credit rating” as “a credit rating issued by an external credit rating agency”, while an “external credit rating agency” is in turn defined as “a person who provides credit rating services and who is authorised or registered by a regulatory authority to perform credit rating services similar to those regulated under this Act and who is subject to the laws of a country other

independence of credit rating agencies. Chapter 6 makes provision for the powers and functions of the registrar and deputy registrar of Credit rating agencies to administer the Act, which powers include the ability to make rules, authorise inspections, issue directives and cooperate with other regulatory authorities. Chapter 7 contains provisions relating to enforcement actions and remedies by *inter alia* empowering the registrar to take civil action in instances of non-compliance with the Act and providing specificity with regards to offences and penalties. Chapter 8 contains ordinary general provisions, including empowerment of the Minister to make regulations. Some of the more notable aspects of the Act are dealt with in the subsections that follow.

#### 4.2. Application

The Act applies to “credit rating services performed in the Republic, credit ratings that are issued by credit rating agencies registered in the Republic and any person that performs credit rating services or issues credit ratings in the Republic”.<sup>125</sup> Importantly, the Act does not apply to private credit ratings or credit ratings services produced pursuant to individual orders and provided exclusively to the person who placed the order and which are not intended for public disclosure.<sup>126</sup> A wide class of persons and activities are envisaged to fall under the Act in accordance with the definitions of ‘credit rating’, ‘credit rating agency’ and ‘credit rating services’:

“**credit rating**” means an opinion regarding the creditworthiness of—

- (a) an entity;
- (b) a security or a financial instrument; or
- (c) an issuer of a security or a financial instrument,

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than the Republic, which laws (a) establish a regulatory framework which is approved by the registrar as being equivalent to that established by this Act; and (b) are supervised and monitored by a regulatory authority”.

<sup>125</sup> S 3(1). There are currently five credit rating agencies operating in South Africa: Moody's Investor Services Limited or Moody's Investor Services South Africa (Pty) Ltd, Fitch Rating Limited or Fitch Ratings Southern Africa (Pty) Limited, Standard & Poor's, Global Credit Rating Co and Ratings Africa. See Sabinet Bill Tracker ‘Credit Ratings Services Act’ available at <http://discover.sabinet.co.za/document/BTD10640> accessed on 13 August 2013.

<sup>126</sup> S 3(4).

using an established and defined ranking system of rating categories, excluding any recommendation to purchase, sell or hold any security or financial instrument;

“**credit rating agency**” means a person who provides credit rating services;

“**credit rating services**” means data and information analysis, evaluation, approval, issuing or review, for the purposes of credit ratings.<sup>127</sup>

The legal effect of the Act is that no person who purports to provide credit ratings or credit rating services may lawfully do so without evidence of valid registration therefor.<sup>128</sup> There is thus a legal duty on credit rating agencies to be validly registered as such in order to carry on their business in the Republic.



**Figure 5**

#### *4.2.1. Registration*

The Act imposes strict requirements in respect of registration applications. In addition to providing for the corporate, personnel and administrative details ordinarily associated with any license-type application,<sup>129</sup> the application for registration must include details of the credit rating agency’s “policies and

<sup>127</sup> S 1.

<sup>128</sup> S 3(2).

<sup>129</sup> S 5(a) - (b).

procedures” to determine, disclose and manage conflicts of interests,<sup>130</sup> details of compliance with the code of conduct contemplated in s 11,<sup>131</sup> a description of the actual procedures and methodologies that are to be used in the review and issue of credit ratings,<sup>132</sup> and information to the satisfaction of the registrar that the rating agency applicant, all directors and its employees satisfy the prescribed ‘fit and proper’ requirements concerning personal qualities relating to “honesty and integrity, competence, operational ability and financial soundness”.<sup>133</sup> The registrar is empowered to grant or refuse applications for registration and retains a general discretion to exempt applicants from black letter compliance with the Act,<sup>134</sup> possibly in line with a broader move to favouring “substantial compliance”, as in the Companies Act.<sup>135</sup> The registrar is also empowered to suspend or cancel registrations in certain circumstances.<sup>136</sup>

#### 4.2.2. *Statutory duties imposed on registered rating agencies*

Registered rating agencies are subject to extensive duties under the Act. These duties pertain to informing the registrar of the appointment of directors,<sup>137</sup> adhering to the stipulated requirements in respect of the methodologies, models and key rating assumptions to be used in the issue of ratings and other general requirements.<sup>138</sup> Registered rating agencies are required to adopt a code of conduct,<sup>139</sup> solicit and acquire the registrar's approval before attempting to outsource any of the functions it would ordinarily perform,<sup>140</sup> make prescribed operational and financial disclosures,<sup>141</sup> maintain records, publish annual reports and financial statements,<sup>142</sup> and, finally, institute a permanent, independent compliance unit that performs on-going functions.<sup>143</sup>

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<sup>130</sup> S 5(b)(vii).

<sup>131</sup> S 5(b)(ix).

<sup>132</sup> S 5 (c).

<sup>133</sup> S 5 (d).

<sup>134</sup> S 5(3).

<sup>135</sup> See S 6 (a) & (b).

<sup>136</sup> S 6(1).

<sup>137</sup> S 8.

<sup>138</sup> S 9.

<sup>139</sup> S 11.

<sup>140</sup> S 12.

<sup>141</sup> S 13.

<sup>142</sup> S 14-15; S 17.

<sup>143</sup> S 16.

#### 4.2.3. *Local endorsement in respect of 'external' ratings*

Registered rating agencies are permitted by the Act to endorse the credit rating of a person who is authorised to perform credit rating services that are similar to those regulated under the Act by the laws of a country outside of South Africa, but only provided that the laws in question establish an approved, equivalent regulatory framework and that they are supervised for compliance by a regulatory authority,<sup>144</sup> and subject also to certain other requirements.<sup>145</sup> The effect of endorsement is that the credit rating is deemed to have been issued by the registered credit rating agency in question.<sup>146</sup> Liability for endorsed credit ratings attaches to the registered credit rating agency in question and they cannot escape this on the basis that a particular rating was not their doing.<sup>147</sup> The intention of this section is to permit credit rating agencies with South African operations to use credit rating services conducted by branches in other jurisdictions that are deemed by the registrar to be regulated by laws that are sufficiently equivalent to the laws of South Africa.<sup>148</sup>

#### 4.2.4. *Liability of registered credit rating agencies*

As suggested above, there is some debate regarding whether or not civil liability for credit rating agencies is, in fact, a useful deterrent against negligent behaviour. The argument against it is that maintenance of reputational capital by profit-maximising ratings agencies should, in and of itself, provide enough of an incentive to ratings agencies to act in the best interests of capital market participants.<sup>149</sup> The idea is that if credit ratings agencies provide inaccurate and unreliable ratings, they will forego profits. However, our legislature has taken a firm view, eschewing the market mechanism implied by reputational capital theory in favour of a policy decision to subject credit rating agencies to delictual liability under Section 19 of the Act:

**19. Liability of registered credit rating agency.**—(1) A registered credit rating agency may be delictually liable, in respect of a credit

<sup>144</sup> S 1 definition of “external credit rating agency”.

<sup>145</sup> S 18.

<sup>146</sup> S 18(2).

<sup>147</sup> S 18(3).

<sup>148</sup> National Treasury response document to comments received on the Credit Ratings Services Bill as tabled in parliament on 5 March 2012 at 10 available to Sabinet subscribers at [http://discover.sabinet.co.za/webx/access/policydocuments/policies12/DL061285\\_pt2.pdf](http://discover.sabinet.co.za/webx/access/policydocuments/policies12/DL061285_pt2.pdf) accessed on 13 August 2013.

<sup>149</sup> Ellis, Fairchild & D’Souza op cit note 7 at 211.

rating issued or credit rating services performed in the ordinary course of business in terms of this Act, for any loss, damages or costs sustained as a result of such credit rating or credit rating service.

(2) Subsection (1) does not affect any additional or other liability of a registered credit rating agency to an investor or member of the public, arising from a contractual relationship or the application of any law.

The latter parts of Section 19 contain provisions relating to the independence of credit rating agencies which prohibit any person from “hindering, interfering with, obstructing or improperly attempting to influence a credit rating’s content, methodology, model or assumptions”.<sup>150</sup> It is not immediately clear what sanction or liability the Act envisages for a breach of this latter provision,<sup>151</sup> but such an investigation is beyond the scope of this paper.

## **5. Common law delictual liability of credit rating agencies to investors**

### *5.1. Introduction*

What does the liability provision in the Act entail for rating agencies in South Africa? Given that this legislation is completely novel, and also the dearth of any court decisions involving rating agencies, there is work to be done in establishing what this actually means for market participants and potential litigants.<sup>152</sup> As is plainly evident in Section 19, the Act purports to employ the common law of delict to govern the liability regime of credit rating agencies.<sup>153</sup> National Treasury’s view was that this is “the most practical approach” owing to the fact that the principles of common law delictual liability are “well established in our law”.<sup>154</sup> The law of delict is concerned with ‘righting wrongs’, and in South Africa, a defendant commits a delict *vis-à-vis* a plaintiff if and only, by act or omission, the defendant infringes the plaintiff’s non-contractual right and the law justifies holding the defendant to a duty

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<sup>150</sup> S 19(2). This includes the registrar.

<sup>151</sup> Indeed, s 32, which purports to deal with offences and penalties, makes no reference to transgressions of the s 19 independence provisions.

<sup>152</sup> Swanepoel op cit note 4.

<sup>153</sup> In this regard, Treasury seems to have followed the advices of counsel and academics almost to the letter. Cf National Treasury response document op cit note 148 at 4 and Locke op cit note 94 at 560.

<sup>154</sup> National Treasury response document op cit note 148 at 4.

to compensate the plaintiff.<sup>155</sup> In essence, this means that the law in certain circumstances deems that a loss should lie not where it falls,<sup>156</sup> but should in fact lie, at least in part, with the person responsible for causing it.

The liability envisaged by the Act that is relevant for present purposes is the case where a rating agency publishes negligent misstatements in its ratings and a third party investor relies on those misstatements to its detriment (that is, the value of the investment depreciates or, more likely, is lost outright). As suggested earlier, it has been argued that the role of the rating agency in contributing to an investor's loss is similar to that of an auditor of a company who provides a clean audit report when it should have been qualified,<sup>157</sup> because while the company contracts with the auditor for the provision of audit services, in reality many third parties, including investors, rely on the strength of the auditor's opinion in dealing with the company.<sup>158</sup> The same is said to be true of ratings agencies. The gist is that while issuers of debt securities certainly solicit credit ratings services themselves, investors also rely heavily on those credit ratings in reaching their investment decisions.

Accordingly, in the event that an investor suffers a loss on the basis of reliance on negligently misstated credit ratings, can *she* sue the credit rating agency? Unlike auditors, there are no established guidelines for liability in the case of their negligent misstatement. Further, we also know that rating agencies owe investors no contractual duties because there is no privity of contract between them—any contract for the provision of rating services gives rise to rights and duties between the issuer and the rating agency only (that kind of a contractual relationship would be helpful in defining the ambit of any liability). So, the narrow question relevant for present purposes remains this: do credit rating agencies owe *non-contractual* duties to a wider class of persons than just the debt securities issuer to not make negligent misrepresentations in their ratings?

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<sup>155</sup> Daniel Visser 'Delict' in Du Bois et al *Wille's Principles of South African Law* 2007 9ed 1089 at 1092.

<sup>156</sup> Harms JA notes in *Telematrix (Pty) Ltd v Advertising Standards Authority SA* (459/2004) [2005] ZASCA 73 at 12 that this idea is captured by the exception to the Afrikaans aphorism 'die skade rus waar dit val'.

<sup>157</sup> Locke op cit note 87 at 54.

<sup>158</sup> Richard Jooste in Cassim op cit note 122 at 572; Locke op cit note 87 at 54.

*5.2. The principles of delictual liability for pure economics loss caused by negligent misstatement in South African law*

The South African law of delict requires that four elements be present before a defendant can be assigned delictual liability in respect of a plaintiff's loss caused by the defendant's conduct. The universal requirement of the four elements means that South African law takes a "generalising" approach to delictual liability,<sup>159</sup> as opposed to the ordinary common law approach where liability is governed by a discrete set of established torts, each of which has unique requirements.<sup>160</sup> As suggested above, for delictual liability to be imposed in South African law there must have been some blameworthy conduct on the part of the defendant (in our case, a negligent misstatement), which conduct caused harm to the plaintiff and which was also wrongful.<sup>161</sup> In the section that follows, each of the elements constituting this delict will be examined in detail in so far as they relate to a claim by an investor against a credit rating agency for the purely economic loss he suffers in reliance on a negligently prepared credit rating.

*5.2.1. Conduct that causes harm*

The requirement of proving harm-causing conduct on the part of the defendant is likely to be one of the least contentious. All that needs to be proved is that the rating agency misrepresented the debtor's risk of default,<sup>162</sup> which representation will be in the form of a published ratings document attributable to the agency in question. Thereafter, the very fact of the commencement of litigation by a third party investor will in all likelihood indicate that the relevant rating was not accurate to the extent that the plaintiff is motivated to recover compensation for his losses.<sup>163</sup> The investor would have had his interest in his investment set back sufficiently by the conduct of the defendant to prompt him to seek its recovery. This fact of the investor plaintiff's

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<sup>159</sup> J Neethling, J Potgieter & PJ Visser (translated by JC Knobel) *Law of Delict* 2006 5ed at 4.

<sup>160</sup> This is not to say that the common law has not had a pervasive and lasting impact on our hybrid system. English common law in particular has been extremely influential in the development of South African law, with references to their concept of a 'duty of care' appearing in Appellate Division judgments as early as 1910. See e.g. CG Van der Merwe, J Du Plessis, M de Waal, R Zimmerman & P Farlam in V Palmer (ed) *Mixed Jurisdictions Worldwide: The Third Legal Family* 2012 2ed at 175.

<sup>161</sup> Neethling, Potgieter & Visser op cit note 159 at 1.

<sup>162</sup> Locke op cit note 87 at 55.

<sup>163</sup> Locke op cit note 87 at 56.

loss necessarily entails satisfaction of the other aspect of the conduct element, that is, the conduct must have also been “harm-causing”.

### 5.2.2. *Negligence*

The standard of fault alleged by a plaintiff investor will almost invariably be negligence. It is highly unlikely that a ratings agency would intentionally award an inaccurate rating in respect of a debtor, but if it did, the plaintiff would bear the onus of demonstrating this. In any event, this paper’s analysis is restricted solely to negligence as the fault standard, which is submitted to be a much more likely situation. The test for negligence is very well established in South African law:<sup>164</sup>

“For the purposes of liability *culpa* [negligence] arises if—

- (a) a *diligens paterfamilias*<sup>165</sup> in the position of the defendant—
  - (i) would foresee the reasonable possibility of his conduct injuring another in his person or property and causing him patrimonial loss; and
  - (ii) would take reasonable steps to guard against such occurrence; and
- (b) the defendant failed to take such steps.”

The above test gives content to the true of criterion of negligence being “whether in the particular circumstances the conduct complained of falls short of the standard of the reasonable person”.<sup>166</sup> Judicial decisions have given clarity with regards to the types of attributes the ‘reasonable person’ might have,<sup>167</sup> thereby setting a kind of objective standard. The standard of reasonableness increases with special expertise,<sup>168</sup> real or professed, but is never lowered.<sup>169</sup> The requirement that a reasonable person in the position of the defendant would have taken precautionary steps must not be forgotten. Four factors are considered to this end: (i) the degree or

<sup>164</sup> *Kruger v Coetzee* 1966 (2) SA 428 (A).

<sup>165</sup> A *diligens paterfamilias* is the so-called reasonable man, derived from the Latin for ‘head of a family’, the management of his household’s affairs being considered a model of prudence and caution.

<sup>166</sup> Scott JA in *Sea Harvest Corporation (Pty) Ltd v Duncan Dock Cold Storage (Pty) Ltd* 2000 (1) SA 827 SCA 21.

<sup>167</sup> Visser op cit note 155 at 1126 fn 186.

<sup>168</sup> *Van Wyk v Lewis* 1924 A D 438 444 confirmed in *Durr v Absa Bank Ltd and Another* (424/96) [1997] ZASCA 44.

<sup>169</sup> Visser op cit note 155 at 1126 fn 189.

extent of the risk created by the actor's conduct, (ii) the gravity of the possible consequences if the risk of harm materializes, (iii) the utility of the actor's conduct, and (iv) the cost of eliminating the risk of harm.<sup>170</sup> These factors inform a weighing of the magnitude of a risk against the cost and benefit of taking the precautions in question,<sup>171</sup> and accordingly the facts of a case are always decisive.<sup>172</sup>

The crisp question, then, in determining whether a credit rating agency was negligent in its rating activities is whether its conduct falls short of that of a reasonable credit rating agency. A judge will be required to make a determination in this regard based on evidence led in court. It must be borne in mind that in the absence of particularly glaring evidence, this will in all probability be a difficult exercise and require testimony from expert witnesses with specialist knowledge. Rating agencies pride themselves on the complexity of the models they employ and it will take considerable effort and skill on the part of the plaintiff to be able to prove that they were negligent in their work. In spite of this, motivated litigants and competent judging have done exactly this with obvious successes in the common law world already.<sup>173</sup>

### 5.2.3. *Wrongfulness*

Wrongfulness is a stand-alone and central element of delictual liability in South African law.<sup>174</sup> Thus, it is not enough that negligent conduct by a defendant causes plaintiff harm, it must rather be the case that the conduct in question is also 'wrongful'. The presence of wrongfulness in a particular instance of loss-causing conduct is a question of judicial discretion, which discretion has on occasion "hardened" into rules that generate rebuttable presumptions about the presence or absence of wrongfulness in certain instances.<sup>175</sup> For example, there is a presumption of wrongfulness where a person's positive conduct causes physical injury to another, or where a person steals another's property. In spite of the crystallisation of rules that generate presumptions about the existence of wrongfulness, judicial discretion is

<sup>170</sup> *Ngubane v SA Transport Services* 1991 (1) SA 756 (A) at 776H-I.

<sup>171</sup> Visser op cit note 155 at 1127.

<sup>172</sup> As suggested in Visser op cit note 155 at 1126, repeated fact patterns do however yield non-binding but persuasive rulings on what constitutes reasonable conduct in particular types of circumstances.

<sup>173</sup> See e.g. the *Bathurst* case supra note 5.

<sup>174</sup> *Minister van Polisie v Ewels* 1975 (3) SA 590 (A).

<sup>175</sup> Anton Fagan 'Rethinking wrongfulness in the law of delict' (2005) 122 *The South African Law Journal* 90 at 90.

sometimes used to give clarity to a vague distinction, to fill a gap in the rules or to allow an exception to them.<sup>176</sup> Judicial discretion is used in the application of a ‘general test’ for wrongfulness. This test that says that the wrongfulness of conduct that also causes harm is dependent on ‘the legal convictions of the community’ or ‘considerations of policy’.<sup>177</sup> It goes without saying that this is a rather empty definition.

In giving more meaning to this concept adherents of the so-called “standard view” of wrongfulness say that wrongfulness on the general test is determined with reference to the ex post facto reasonableness of conduct, or ‘objective reasonableness’.<sup>178</sup> It is submitted, however, that the standard view has been convincingly demonstrated to be flawed.<sup>179</sup> The argument against the standard view is that while in certain instances the presence of wrongfulness turns on the ex ante reasonableness of conduct, outside of those instances any references to reasonableness in the wrongfulness enquiry are in fact references to the whether it is reasonable to impose liability on the defendant towards the plaintiff for the harm that resulted from that unreasonable conduct.<sup>180</sup> It has been argued that there is strong evidence to support this view, principally that the courts expressly endorse it and secondarily that the courts impliedly endorse it in two ways, firstly by the factors that they look at in making a determination on wrongfulness in certain cases and secondly by their assertion that the wrongfulness of certain types of conduct arises from the breach of a “duty to act without negligence”.<sup>181</sup> One area where this is plain is in the province of “pure economic loss”, as in the case at hand.

“Pure economic loss” cases present particular conceptual difficulties in establishing wrongfulness in South African law for reasons of principle. In Roman

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<sup>176</sup> Fagan op cit note 175 at 90.

<sup>177</sup> Fagan op cit note 175 at 94, particularly the cases cited in fn 20.

<sup>178</sup> Fagan op cit note 175 at 92.

<sup>179</sup> FDJ Brand ‘The contribution of Louis Harms in the sphere of Aquilian liability for pure economic loss’ (2013) 76 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 57; RW Nugent ‘Yes, it is always a bad thing for the law: a reply to Professor Neethling’ (2006) 4 *The South African Law Journal* 557. Visser op cit note 88 at 1097 fn 11; Fagan op cit note 175 at 92. It appears that the National Treasury committee responsible for the production of the Credit Ratings Services Act had in mind the “standard view” of wrongfulness. Whether anything turns on this remains to be seen. See National Treasury response document op cit note 148 at 6.

<sup>180</sup> Fagan op cit note 175 cites the examples of self-defence, qualified privilege and the reasonable publication by the press of a false defamatory statement.

<sup>181</sup> Fagan op cit note 175 at 106.

times, the *Lex Aquilia* protected only bodily integrity and real rights.<sup>182</sup> Thus, if there was no physical damage to property or person interposing a loss to patrimony, there could be no claim for compensation. Later extensions of the Aquilian principles in Roman-Dutch Law also did not go far enough to give rise to a general remedy for wrongfully caused patrimonial loss,<sup>183</sup> but the modern position is different. Today it is established law that a plaintiff may sue for compensation for pure economic loss in accordance with the ordinary principles of Aquilian liability, but the presence of wrongfulness is not presumed, as it is in the case of physical injury.<sup>184</sup> Most importantly for present purposes, South African courts have held that a plaintiff can bring an action for loss of a purely economic nature that was occasioned by an alleged negligent misstatement on the part of a defendant.<sup>185</sup> However, the circumstances in which our courts find make a finding of wrongfulness in pure economic loss claims are heavily circumscribed and considerations of public and legal policy are always determinative.<sup>186</sup> Having said that, in certain categories of claims it has become the practice of the courts to impose liability “as a matter of course”.<sup>187</sup> For example it has been held that collecting banks owe a legal duty to lawful owners of cheques,<sup>188</sup> and that road users whose negligence causes a toll road to be closed are liable to the toll operator that loses revenue as a consequence.<sup>189</sup>

The courts in South Africa (and, indeed, abroad) always approach new categories of pure economic loss cases with circumspection on the basis of two universal arguments.<sup>190</sup> Firstly there is the argument that allowing the imposition of such liability would be “socially calamitous” because society would be placed under an “almost intolerable burden on legitimate human activity”.<sup>191</sup> Secondly there is the spectre of so-called ‘limitless liability’ (limitless in both magnitude and in respect of a multiplicity of plaintiffs) that arises because of the absence of the brake on liability normally provided by the fact of measureable physical damage suffered by a person

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<sup>182</sup> Neethling, Potgieter & Visser op cit note 159 at 7-9.

<sup>183</sup> Neethling, Potgieter & Visser op cit note 159 at 9 fn 50.

<sup>184</sup> Neethling, Potgieter & Visser op cit note 159 at 9 fn 58.

<sup>185</sup> *Administrateur, Natal v Trust Bank van Afrika Bpk* 1979 3 SA 824 (A).

<sup>186</sup> Visser op cit note 139 at 1105.

<sup>187</sup> *Cape Empowerment Trust Limited v Fisher Hoffman Sithole* (200/11) [2013] ZASCA 16.

<sup>188</sup> *Indac Electronics (Pty) Ltd v Volkskas Bank Ltd* 1992 (1) SA 783 (A).

<sup>189</sup> *Fourway Haulage SA (Pty) Ltd v SA National Roads Agency Ltd* (2009 (2) SA 150 (SCA).

<sup>190</sup> Mauro Bussani, Vernon Palmer & Francesco Parisi ‘The comparative law and economics of pure economic loss’ (2006) *International Review of Law and Economics* 1 at 64.

<sup>191</sup> *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 at 613I – 614A.

or class of persons.<sup>192</sup> These justifications, advanced by courts the world over, sit conveniently on top of our Roman and Roman-Dutch law traditions which both agree that economic loss on its own is not sufficient to justify the imposition of liability.<sup>193</sup> Accordingly the default position in South African law is that claims for pure economic loss are not *prima facie* recoverable; it is instead up to the plaintiff to persuade the court that it ought to be so because of arguments that turn on wrongfulness.<sup>194</sup> That is, there must be policy considerations that dictate the defendant should be saddled with a duty to recompense the plaintiff.<sup>195</sup> Subscribers to the ‘standard view’ have argued that this represents a departure from established precedent,<sup>196</sup> but once again it is submitted that this suggestion has been persuasively rebutted.<sup>197</sup>

The role of the wrongfulness element “a safety valve; a control measure; [or] a long stop” that is used to limit liability for pure economic loss cannot be underemphasised.<sup>198</sup> It is important to point out that what is required in a court’s policy analysis is not “an intuitive reaction to a collection of arbitrary factors but rather a balancing against one another of identifiable norms”.<sup>199</sup> Often the charge is made that the introduction of policy factors as reference markers for judges can introduce uncertainty in the law.<sup>200</sup> Indeed, as Brand JA noted in *Fourway Haulage SA (Pty) Ltd v SA National Roads Agency Ltd*,<sup>201</sup> a “legal system in which the outcome of litigation cannot be predicted with some measure of certainty would fail in its purpose”.<sup>202</sup> Given the importance that the courts attach to the ostensibly

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<sup>192</sup> Hence the memorable and somewhat apocalyptic dictum from Cardozo J in *Ultramares Corporation v George A Touche* 74 ALR 1139 at 1145: “if liability for negligence exists... there is the danger of liability in an indeterminate amount for an indeterminate time to an indeterminate class.”

<sup>193</sup> Justinian *The Digest of Roman Law: Theft, Rapine, Damage and Insult* (translated by CF Kolbert) at 9.2.27 and 9.2.21.

<sup>194</sup> Visser op cit note 139 at 1106.

<sup>195</sup> *Telematrix* supra note 156 at para 12.

<sup>196</sup> Brand op cit note 179 at 58.

<sup>197</sup> *Ibid.*

<sup>198</sup> *Ibid* at 61.

<sup>199</sup> *Telematrix* supra note 156 at para 12.

<sup>200</sup> Brand op cit note 179 at 63.

<sup>201</sup> The *Fourway* case supra note 189.

<sup>202</sup> Brand JA refers in that judgment to Lord Scott of Foscote in *Lagden v O’Conner* [2003] UKHL 64 para 86:

“One of the main functions of the law of obligations... is to provide... a set of yardsticks for determining whether a legal injury has been inflicted on a person (the claimant) by another person (the defendant). If the two parties are unable to agree, an answer can be found by recourse to

nebulous concept of ‘policy’, what, exactly, are the factors that the courts consider in practice? It has been emphasised repeatedly<sup>203</sup> that there is no closed list but in the context of negligent misrepresentations the courts have held that important considerations include:

- (a) The plaintiff’s vulnerability to the risk;
- (b) Whether the extension of liability would impose a burden on the defendant that is not warranted;
- (c) the nature and proximity of the parties’ relationship;
- (d) whether the statement was made in the course of a business context or in providing a professional service;
- (e) the professional standing of the maker of the statement;
- (f) the extent of the plaintiff’s reliance on the defendant for information and advice; and
- (g) the reasonableness of the plaintiff relying on the accuracy of the statement.<sup>204</sup>

How might each of these factors apply in the context of a negligent misstatement by a rating agency? It is submitted that the following considerations would be in the forefront of the court’s mind when reasoning through the factors. First, the likely plaintiff’s vulnerability to the risk of an inaccurate credit rating would depend on their having the means of performing equivalent or approximating analyses internally, and thereby being able to reliably ‘check’ the work of the rating agency. Whilst it is certainly true that many large institutional investors do have such resources, this is not true of the entire market and almost certainly not true in the case of government investors. Second, it is not clear that the extension of civil liability would place an unwarranted burden on a rating agency. Recent developments in the regulation of their industry have already gone a significant way

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litigation. But the cost of litigation... provide impelling reasons why the yardsticks of... legal liability... should be kept as simple... as practicable."

<sup>203</sup> See *inter alia* the *Telematrix* case supra note 156; *Delphisure Group Insurance Brokers Cape (Pty) Ltd v Kotzé and others* [2011] 1 All SA 109 (SCA); The *Cape Empowerment Trust* case supra note 187.

<sup>204</sup> The *Delphisure* case supra note 203 at para 25.

in ensuring that appropriate standards of due diligence are maintained,<sup>205</sup> and it requires no stretch to see that breach of these standards of care is sanctioned by liability. Third, the nature and proximity of the parties' relationship would be judged with reference to the extent to which the rating agency was aware of the class of persons who might constitute plaintiffs, and whether it expected them to rely on its statements. Rating agencies are without doubt well aware that investors take heed of their ratings, and that they might do so in coming to investment decisions. Fourth, rating agencies publish their ratings exclusively in business contexts and they do so while holding themselves out as professionals of high standing in their field. In other words, they claim special knowledge by dint of rigorous, professional expertise and engender a sense of confidence in the market that the information they provide is accurate.<sup>206</sup>

If a plaintiff investor can make a case for the presence of wrongfulness on at least some of the listed grounds (which by no means constitutes a *numerus clausus*), she can be hopeful, at least, of persuading a court to agree. The very fact of plaintiffs being successful in novel instances in the past is evidence of the viability of such a strategy.

#### 5.2.4. Causation

For the causation element of a delict to be satisfied, the tests for both factual and legal causation must be met.<sup>207</sup> Factual causation implies that it must have been the case that the defendant's negligent conduct is what actually caused the plaintiff to suffer the harm, colloquially described as the "but for" test as articulated in *Minister of Police v Skosana*<sup>208</sup> and followed ever since.<sup>209</sup> This test entails that the negligent conduct in question must have been a necessary condition in the outcome that eventuated. It has been suggested that the barriers to proving factual causation in the

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<sup>205</sup> See Chapter 4 *infra*.

<sup>206</sup> As will be demonstrated, the last two factors are intertwined and present difficulties for plaintiffs. It is not immediately clear that it is reasonable for an investor to forego common sense or any due diligence on its own part in placing excessive reliance on a third party's predictions, and it is also not clear to what extent investors actually base their decisions on ratings.

<sup>207</sup> *International Shipping Company (Pty) Ltd v Bentley* 1990 (1) SA 680 (A).

<sup>208</sup> 1977 (1) SA 31 (A) and confirmed in *Siman & Co (Pty) Ltd v Barclays National Bank Ltd* 1984 (2) SA 888 (A).

<sup>209</sup> This is in spite of academic criticism. See e.g. Neethling, Potgieter & Visser *op cite* note 159 at 279.

case of reliance on a negligent misrepresentation in a credit rating are quite low,<sup>210</sup> because third party investors will almost always rely on ratings provided by ratings agencies in making their investment decisions. But is this really as straightforward as it seems? Consider the following example that demonstrates the need for nuance in the application of the test for factual causation. B seeks investment advice from A, and A responds by giving two misstatements, X and Y, about a particular investment product. Imagine that B relies on both in making his (failed) investment, and further that X was a negligent misstatement on A's part but Y was a non-negligent misstatement. Imagine finally that even if the advice had not contained X, B would still have made the investments, but that if it had not contained Y, B would not have made the investments. In this case, A is not delictually liable even though he acted negligently and he caused B's loss. This is because the negligence itself did not cause the loss, and so A's negligence was not a necessary condition for the harm. Remember, it was assumed that misstatement X was negligent but not necessary for B to make the bad investment; and that misstatement Y was necessary but was non-negligent. Accordingly, in fewer words, for the factual causation test to be satisfied it must be the case that the *actual negligent conduct* in question was a necessary condition for the loss that eventuated.

Legal causation, on the other hand, operates as a brake on liability in that certain consequences are deemed by our law to be so remote from the conduct that caused them that they are unforeseeable and accordingly defendants should not be liable for them. In this way its function is in some ways similar to the wrongfulness element. Legal causation extends only so far as courts see fit in any given fact set in accordance with this authoritative statement from Corbett CJ in *Standard Chartered Bank of Canada v Nedperm Bank Ltd*:<sup>211</sup>

“[The test for legal causation] is a flexible one in which factors such as reasonable foreseeability, directness, the absence or presence of a *novus actus interveniens*, legal policy, reasonability, fairness and justice all play their part.”

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<sup>210</sup> Locke op cit note 87 at 56.

<sup>211</sup> 1994 (4) SA 747 (A).

At least one author argues that legal causation will be a significant barrier to third party investors who actually rely on rating agencies.<sup>212</sup> The idea is that such third parties are most often highly sophisticated, wealthy institutional investors who use a much more rigorous process in coming to their investment decisions than merely relying on ratings. On this line of reasoning it becomes very difficult to show that a rating agency's opinion (however reputable it may be) factored significantly into the investor's decision-making process. It is submitted that the very same factors that figure in the court's reasoning in coming to a determination with regards to wrongfulness will figure at this stage, too. It is thus important to realise that mere foreseeability of loss is insufficient: foreseeability is but one factor that may in any event be defeated by policy reasons, and vice versa.

It is interesting to note the suggestion from Treasury that in the case where an investor places excessive reliance on a credit rating, that may possibly constitute a *novus actus interveniens* if it amounts to "carelessness" that breaks the causal chain between the defendant's conduct and the harm in question.<sup>213</sup> This may well be the case where an investor completely forgoes even the most rudimentary investigation on his own part, and aspirant plaintiffs should bear that in mind. That being said, a plaintiff's meeting the factual causation test in the classic rating agency case should not prove insurmountable, and provided wrongfulness can be proved it is likely that the test for legal causation can be met, too.

## **6. Lessons from abroad: selected common law jurisdictions**

Common law jurisdictions assign negligence liability to defendants who breach an objective duty of care owed to plaintiffs. Just as in South Africa, in some instances this is straightforward (as in the case of physical injury) but in the case of pure economic loss the default position is the same and losses are not recoverable.<sup>214</sup> The classic justification for this was summarised by Cardozo J in *Ultramares Corporation v. Touche*<sup>215</sup> who said allowing such claims would result in "liability in an indeterminate amount, for an indeterminate time, to an

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<sup>212</sup> Locke op cit note 87 at 54.

<sup>213</sup> National Treasury response document op cit note 148 at 7.

<sup>214</sup> The same is true for nearly all jurisdictions, including traditional continental civil ones. See e.g. Erwin Deutsch translated by Tony Weir 'Compensation for pure economic loss in German law' in E Banakas (ed) *Civil liability for pure economic loss* 1996 73 at 74.

<sup>215</sup> 174 N.E 441, 444 (N.Y. 1931).

indeterminate class”. Despite this default position, all jurisdictions (be they common or civil law) permit recovery of pure economic loss in limited, exceptional circumstances. In common law jurisdictions there are accordingly established categories of exceptions that are expanded in increments by case law.

Each of English, Australian and United States law are highly relevant comparisons for the South Africa context. First, English law is highly influential on the South African law of delict for historical reasons, with local courts classically following the lead of the House of Lords and citing their jurisprudence with approval particularly with regard to developing the element of wrongfulness viewed in light of the English ‘duty of care’ concept. Second, Australian courts are similarly observant of English legal developments, and since theirs is the only jurisdiction where a court has taken the leap of actually imposing a duty of care on a ratings agency, their experience is ripe for comparison. Third, the United States is relevant because of its highly litigious culture, and the real possibility of a very similar suit being decided in the very near future.<sup>216</sup> It will therefore be most instructive to look first at Australia, which has defined the circumstances giving rise to ratings agency liability under the common law, and then infer how United States and English courts are likely to judge similar facts under their own laws. The central question remains universal: when will courts forsake the principal of *caveat emptor* in order to allow an investor an action for recovery?

### 6.1. Australia

As explained in the introduction to this dissertation, nowhere has rating agency liability been treated as severely as it has in Australia. One especially noteworthy judgment, *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)*,<sup>217</sup> is reverberating around the common law world and providing the impetus for litigators in other jurisdictions to pursue the claims of disappointed investors.<sup>218</sup> (This case should be considered in the context of a separate but contemporaneous judgment, *Wingcarribee*, which made similar findings on related

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<sup>216</sup> See Chapter 6.3 *infra*.

<sup>217</sup> The *Bathurst* case *supra* note 5.

<sup>218</sup> For example, see the video report Greg Hoy ‘Australia’s Triple A credit rating and the agencies that bestow those ratings’ available at <http://www.abc.net.au/7.30/content/2013/s3851806.htm> accessed on 15 September 2013 that strongly suggests similar claims will be pursued in both The Netherlands and the United Kingdom.

facts regarding structured credit products, but with regards to a bank as defendant instead of a ratings agency.)<sup>219</sup> The judgments are both very long, 450 pages in *Wingcarribee* and 1459 pages in *Bathurst*, partly as a consequence of the complexity of the structured credit products in question but also partly because of the significant detail in which the judges dealt with the tangled issues of:

- i. the duty of care owed by a ratings agency,
- ii. the meaning to be attached to a credit rating when supplied by an entity that is not a credit rating agency, and
- iii. how to determine the existence of fiduciary and advisory duties in an investment advice relationship.

Prior to this judgment there was a general reluctance for Australian courts to assign liability for what amounted to plaintiffs' reliance on 'investment advice', the idea being that in the course of their work, financial advisors provide various recommendations and they should not be responsible for the way in which their advices are used. The same was thought to apply in respect of investor reliance on ratings provided by rating agencies. In the *Bathurst* case the Federal Court of Australia was faced with a claim by multiple Australian local councils who had lost money invested in complex, highly leveraged credit derivatives called 'constant proportion debt obligations' (CPDOs). The CPDOs took the form of notes issued by an SPV created expressly for that purpose by Dutch investment bank ABN Amro. The performance of the CPDOs depended firstly on the continuation over their ten-year life of a technical phenomenon known as the 'mean reversion' of their credit curve spread. Second, they were structured in such a way that if they incurred losses over a sustained period because of prolonged departure from the credit curve spread's mean, the CPDO holders would be required to engage in a "fight to the death" and "double down" by increasing investments when performance fell in order

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<sup>219</sup> In *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq)* [2012] FCA 1028 three local councils, Wingecarribee, Swan and Parkes, brought an action against a Lehman subsidiary for losses sustained in respect of AA-rated CDO products they had bought from Lehman. These products plummeted in value with the global sell-off for these products in the financial crisis. The councils argued that Lehman had breached the CDO sale agreements because the merx did not, in fact, have the characteristics promised, namely suitability as conservative investments, high liquidity and a very high security of capital. They also argued that the Lehman subsidiary breached the fiduciary duties it owed as an investment adviser by suggesting products in which they had a profit interest. Rares J agreed with these arguments and held the Lehman subsidiary liable for full losses incurred on the CDOs.

to meet the note's coupon. This was because provided the CPDO was capitalised enough on the downside, the investor would eventually 'win' if he "waited it out", subject to an automatic "cash-out" trigger if the net asset value fell by 90%.<sup>220</sup> These are inherently very risky characteristics for debt securities, and at trial a witness in fact described this practice as "much like the doubling strategy on the roulette table of a casino," where a gambler doubles up after a losing bet in the hope of "bet[ting] yourself out of the hole" to break even or make a return.<sup>221</sup>

Nonetheless, in 2006 prominent rating agency Standard and Poor's (S&P) was engaged to provide a credit rating in respect of the CPDOs, which it did by using stochastic Monte Carlo simulations to quantitatively predict the CPDO's likelihood of default, in addition to various other qualitative measures.<sup>222</sup> It arrived at a AAA rating. When the bank later issued a second and a third tranche of CPDO notes of the same type, S&P purported to perform the same ratings exercise and these latter tranches also received an AAA rating. However, increased volatility in global credit markets and a fall in average spreads meant that by 2007 each of the tranches of the highly geared notes had suffered significant losses.<sup>223</sup> By 2008 S&P had downgraded the latter two notes issues to BBB+ ratings, but the downward spiral continued. The death knell for the products eventually sounded when the automatic cash-out rule was triggered and the investors received back only 6.674% of their initial investments. The councils sought recovery of their massive losses from ABN Amro and its agent, but most importantly for present purposes from S&P who supplied the AAA rating.

Given the complexity of the credit products involved, the court's judgment is technically very thorough in its assessment of S&P's actions. Jagot J takes particular issue with certain assumptions used by S&P in their ratings modelling, heavily criticising some for being excessively optimistic and others for being "arbitrary, irrational and unreasonable".<sup>224</sup> In her view, S&P's modelling of the first and second

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<sup>220</sup> Rommel Harding-Farrenberg & Kieran Donovan 'Duty of care, rating agencies and the 'grotesquely complicated' Rembrandt: Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)' (2013) 14(2) *Business Law International* 185 at 186.

<sup>221</sup> The *Bathurst* supra note 5 at 1230.

<sup>222</sup> Harry Edwards 'Liability for the rating and sale of structured credit products: Australian cases and their (much) wider implications' (2013) *Law and Financial Markets Review* 88 at 89.

<sup>223</sup> Edwards op cit note 222 at 89.

<sup>224</sup> The *Bathurst* case (summary note) supra note 5 at para 25.

tranche could only reasonably anticipate an AAA rating in a very narrow set of circumstances that were, frankly, unrealistic. This resulted in the CPDOs receiving AAA ratings when with standards of reasonable competence they should not have.<sup>225</sup> This problem was compounded by the fact that when S&P was employed to rate the third tranche of the notes (which it knew was to be marketed in a private placement), it again assigned a AAA rating merely on the basis that the bank ‘had said’ that the notes were a “carbon copy” of the first tranche. However, in court they were unable to prove that any modelling had been carried out on these later issues whatsoever.<sup>226</sup> One internal email from S&P was particularly damning:

“This is analytical bs at its worst. I know how those ratings came about and they had nothing to do with the model!”<sup>227</sup>

Jagot J noted at the outset that the credit rating did not amount to “investment advice”, but was rather “a record of an opinion of Standard & Poor’s, which held itself out as having specialist expertise in assessing the creditworthiness of financial products and was intended to be understood as such”.<sup>228</sup> Further, she noted that the role of the court in questioning the standards of care in preparation of the ratings was not to establish what a proper rating would have been, but merely whether the AAA rating was given with a reasonable basis.<sup>229</sup> The judgment goes on to find that three key criteria used by S&P contributed to a rating that was not successful in accurately reflecting the risk associated with the CPDOs. These were the utilisation of a significant number of inputs which S&P should have known to be incorrect,<sup>230</sup> S&P’s failure to factor in exceptional but plausible inputs,<sup>231</sup> and S&P’s failure to anticipate the sensitivity of the CPDOs to very slight changes to the model’s inputs.<sup>232</sup> In addition, S&P’s conduct in accepting the bank’s own model amounted to a departure from the standards of reasonable care and skill demanded of a reasonable ratings agency. Therefore, S&P was liable for negligent misstatement because the AAA rating they had supplied was a statement that in S&P’s opinion—

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<sup>225</sup> Edwards op cit note 222 at 89.

<sup>226</sup> Edwards op cit note 222 at 90.

<sup>227</sup> The *Bathurst* case supra note 5 at 305.

<sup>228</sup> The *Bathurst* case supra note 5 at 1277.

<sup>229</sup> The *Bathurst* case supra note 5 at 2423.

<sup>230</sup> The *Bathurst* case supra note 5 at 2547.

<sup>231</sup> The *Bathurst* case supra note 5 at 2582.

<sup>232</sup> The *Bathurst* case supra note 5 at 2669.

supposedly held on reasonable grounds and after taking requisite ‘reasonable’ care—that the creditworthiness of the CPDO was very strong, when in fact it should have known that it was not.<sup>233</sup> This is a novel finding that warrants close attention. It is significant because it entails that rating agencies owe a very extensive duty of care to a class of persons who, until now, they had been comfortable to largely ignore, specifically potential investors of special vulnerability who are unable to assess a debtor’s creditworthiness themselves or to challenge a rating agency’s opinions.

But is the imposition of a duty of care on a rating agency as straightforward as this judgment suggests? It is worth keeping in mind that this judgment emanates from a court of first instance and will in all probability be appealed. Accordingly, what are the legal issues that an appeal court might investigate further? As suggest above, Australian courts have historically followed the lead of the English courts in pure economic loss cases and the factors taken into account in making a determination as to the existence of a duty to prevent it are very similar: the risk of indeterminate liability, the vulnerability to the loss, the existence of contractual relationships and the directness of relationship between the parties.<sup>234</sup> It has been argued that three factors suggest that an appeal court will agree with the court *a quo*.<sup>235</sup> First, as Jagot J points out, whereas the indeterminacy problem is one that is widely cited in tortious pure economic loss cases as militating against imposing liability, in this case the number of plaintiffs was very small as a consequence of the CPDO’s purchase rules and S&P’s fee incentive scheme which favoured larger, single debt issues over multiple smaller ones.<sup>236</sup> Second, S&P was deemed to have control of the time period during which it owed any duties because it could withdraw its ratings at any time.<sup>237</sup> Third, over and above the judge’s stated reasons, it has been argued that the English requirement that the imposition of the duty be ‘fair, just and reasonable’<sup>238</sup> is more than satisfied because such a duty works to ensure that the opinions of those who purport to provide independent creditworthiness opinions

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<sup>233</sup> The *Bathurst* case supra note 5 at 1153.

<sup>234</sup> The *Bathurst* case supra note 5 at section 12.5.1.

<sup>235</sup> Edwards op cit note 222.

<sup>236</sup> The *Bathurst* case supra note 5 at 2745.

<sup>237</sup> Ibid.

<sup>238</sup> *Perre v Apand Pty Ltd* [1999] HCA 36.

actually do so independently and competently when it is known that the ratings will be used in marketing a particular debt security to investors.<sup>239</sup>

In spite of these compelling arguments in favour of imposing liability, it should be borne in mind that the English courts (and many other common law jurisdictions) are inherently loath to find a duty care exists in novel scenarios, especially when the plaintiff is well placed to guard against the harm in dispute and decides not to.<sup>240</sup> The *Bathurst* court, however, found that the complete reliance by the investors on S&P's rating was reasonable because the particular investors involved did not have the resources or the capacity to "second guess" the rating, but Jagot J did suggest that the position might be different if the investors were sophisticated financial institutions with the means to second guess their opinions.<sup>241</sup>

At least one author has suggested that this reasoning is naïve,<sup>242</sup> the argument being that it is in the nature of ratings of complex credit products that they are prospective likelihood-of-default assessments that rely on base case assumptions that are disclosed and available for inspection by investors. On this view, responsibility for reliance on flawed ratings should rather lie with investors themselves, because they should surely, at the very least, be scrutinising the assumptions employed. Thus, in deciding to buy (or recommend to a client) a particular structured credit product on the strength of its rating, they take responsibility for holding a particular view about the rating agency's assumptions and they must live with that decision. Second, it is not clear that mere unsophistication on the part of the investor should absolve it for bearing any responsibility for losses on its investments. Given the complexity of the financial products at play and the lack of financial expertise on the part of the investors (a fact admitted in *Bathurst*), should they not have taken steps to engage expert financial advice which would have enabled them to come to informed, reasonable investment decisions? It is not clear that the judge distinguished properly the appropriateness of the plaintiffs placing complete reliance on the credit ratings (without applying their own scrutiny), from an implied guarantee by S&P in favour

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<sup>239</sup> Edwards op cit note 222 at 90. The corollary of this is that the liability of ratings agencies is in fact unlike that of auditors because the purposes for which they give their opinions are different: audits are provided for the benefit of a company so that it may comply with its statutory obligations, not for the interest of potential shareholders. See *Caparo Industries Plc v Dickman* [1990] 2 AC 831.

<sup>240</sup> Edwards op cit note 222 at 90.

<sup>241</sup> The *Bathurst* case supra note 5 at 2773.

<sup>242</sup> Edwards op cit note 222 at 91.

of investors, which was certainly neither assumed by, nor in the mind of, any of the parties at any stage prior to the decision to seek recovery.<sup>243</sup>

Finally, it is important to note the court's reluctance to give effect to S&P's disclaimers purporting to exclude liability for reliance on their opinions. These were wide and ostensibly comprehensive:

“The rating is not investment, financial, or other advice and you should not and cannot rely upon the rating as such.”<sup>244</sup>

“Accordingly, any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision.”<sup>245</sup>

“Information has been obtained by Standard & Poor's from sources believed to be reliable. However, because of the possibility of human or mechanical error by our sources, Standard & Poor's, or others, Standard & Poor's does not guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or the result obtained from use of such information.”<sup>246</sup>

All of these attempts at disclaiming liability were rejected by Jagot J, firstly on the basis of their being displayed with insufficient prominence in the relevant communications given their significance,<sup>247</sup> and secondly as a matter of principle, because in her view to allow the disclaimers to stand would have the effect of rendering the very opinion which S&P were being paid to provide “meaningless”.<sup>248</sup> This is arguably defeasible on the basis that investor reliance on a particular rating without further scrutiny (by himself or an expert engaged on his behalf) is not, in fact, reasonable,<sup>249</sup> and to assume that it is, expressly against the advices of a disclaimer, is surely untenable.

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<sup>243</sup> The *Bathurst* case (summary note) supra note 5 at 29.

<sup>244</sup> The *Bathurst* case supra note 5 at 2528.

<sup>245</sup> The *Bathurst* case supra note 5 at 2532.

<sup>246</sup> The *Bathurst* case supra note 5 at 2536.

<sup>247</sup> The *Bathurst* case supra note 5 at 2524.

<sup>248</sup> The *Bathurst* case supra note 5 at 2526 and 2422.

<sup>249</sup> Edwards op cit note 222 at 92.

It should also be noted that in holding that ratings agencies owe a duty of care to investors, the *Bathurst* court was at pains to point out that the circumstances before it were unique.<sup>250</sup> The solicitation of S&P by the bank to rate the CPDOs made it obvious to any reasonable person that the rating given was to be eventually used in the marketing of the CPDOs, and the court pointed out that the outcome might very well be different in the case of an unsolicited rating provided in respect of a public company. It is submitted that this largely accords with our sense of the uneasy, fraught relationship of mutual interest that arises in a “issuer-pays” model, where both the bank and the rating agency are incentivised to ensure that a product in question receives the highest rating possible.<sup>251</sup>



Figure 6

<sup>250</sup> Harding-Farrenberg & Donovan op cit note 220 at 193.

<sup>251</sup> Edwards op cit note 222 at 95.

## 6.2. England

In English law, three tests are traditionally used to decide whether a defendant owes a plaintiff a duty of care in a claim for pure economic loss in tort: (i) the ‘assumption of responsibility’ test, (ii) the ‘threefold’ test (was the plaintiff’s loss a reasonably foreseeable consequence of the defendant’s actions, was the relationship between the parties one of sufficient proximity, and, in the circumstances, is it fair, just and reasonable to impose a duty of care on the defendant?), and (iii) the ‘incremental’ test.<sup>252</sup> Contrary to what one might expect, mere foreseeability by the defendant of the plaintiff’s loss is insufficient to give rise to a duty of care in English law; more is required. That ‘more’ originates in the same factors as those examined in the *Bathurst* case.<sup>253</sup> Given the relative conservatism of the English bench versus the Australia courts, it has been argued that the English courts would likely come to the opposite conclusion about the existence of a duty of care on the *Bathurst* facts.<sup>254</sup> That may well be, however a separate set of international obligations have founded a new action for plaintiff investors in England that will arguably have exactly the same effect.

The United Kingdom is a member of the European Union (EU) and accordingly it is bound to comply with legislation published in the EU’s Official Journal. On 31 May 2013 Regulation (EU) No 462/2013 (“CRA 3”) came into force. As the third iteration of the EU’s response to the role purportedly played by ratings agencies in the financial crisis, CRA 3 requires that member states must ensure that the ratings agencies operating in their territories publish ratings that are founded on “a thorough analysis of all the information that is available” according to the methodologies they profess to employ.<sup>255</sup> A failure to meet this standard gives rise to potential liability under Article 35a:

“Where a credit rating agency has committed, intentionally or with gross negligence, any of the infringements listed in Annex III having an impact on a credit rating, an investor or issuer may claim damages

<sup>252</sup> See the judgment of Lord Bingham in *Her Majesty's Commissioners of Customs and Excise v Barclays Bank Plc* [2006] UKHL 28 and the cases cited therein.

<sup>253</sup> See *infra* Chapter 6.6.1 on the duty of care concept in Australian law.

<sup>254</sup> Edwards *op cit* note 39 at 188.

<sup>255</sup> Edwards *op cit* note 39 at 188.

from that credit rating agency for damage caused to them due to that infringement.”<sup>256</sup>

Although CRA 3 takes the form of an EU Regulation (with which member state compliance is mandatory) as opposed to a Directive (which requires only that a member state achieve a particular result—its means of doing so are discretionary), states are afforded a degree of latitude in order to determine the content of their civil liability regimes.<sup>257</sup> The UK, for its part, has therefore adopted the Credit Rating Agencies (Civil Liability) Regulations 2013,<sup>258</sup> breach whereof can give rise to civil liability (even in spite of a failure to make a determination with regards to a duty of care) on the grounds of a “failure to adopt, implement or enforce adequate measures that ensure ratings are based on a thorough analysis of all information” or a “failure to comply with an agency’s published methodologies”.<sup>259</sup> Accordingly, based on these standards, it requires no stretch to see that liability would be the likely outcome if the *Bathurst* facts were decided under these rules because it was admitted that the ratings given by S&P in *Bathurst* departed from their model.<sup>260</sup>

There is an extra requirement, however, that an investor who brings such an action must be able to demonstrate that it relied reasonably and “in accordance with Article 5a(1) or otherwise with due care” on the rating in question in reaching its investment decision.<sup>261</sup> The effect of this proviso seems to be a pre-emptive defence against frivolous suits brought by disgruntled investors, who are required to show that they conducted their own credit risk assessment under Article 5a(1) or exercised the same degree of care that a reasonably prudent investor would have used in the circumstances.<sup>262</sup> It has been argued that where the investor has not exercised due

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<sup>256</sup> Regulation (EC) No 1060/2009 (as amended), Article 35a.

<sup>257</sup> Brigitte Haar ‘Civil liability of credit rating agencies after CRA 3 – regulatory all-or-nothing approaches between immunity and over-deterrence’ (2013) 2 *University of Oslo Faculty of Law Legal Studies Research Paper Series* 1 at 3.

<sup>258</sup> 2013 No 1637.

<sup>259</sup> Regulation (EC) No 1060/2009 (as amended), Annex III, point 42.

<sup>260</sup> Indeed, one striking piece of evidence in the *Bathurst* case revealed an internal email at S&P where a senior analyst admitted that “the ratings have nothing to do with the model!” See the *Bathurst* case supra note 5 at 305.

<sup>261</sup> Edwards op cit note 39 at 187.

<sup>262</sup> Edwards op cit note 39 at 188.

care but the ratings agency defendant has in fact also been negligent, the principles of contributory negligence will reduce any damages award.<sup>263</sup>

### 6.3. *The United States*

Credit rating agency liability in the United States is unique in that ratings agencies have traditionally enjoyed constitutional protection under the First Amendment.<sup>264</sup> The effect of this is that US courts have treated ratings agencies as if they are journalists who provide editorial ‘opinions’ under the banner of free speech, subject to the proviso that liability will be imposed in instances of “actual malice” where an opinion is published with knowledge of its falsity or with reckless disregard to its truth, a notoriously high hurdle for litigants.<sup>265</sup> US courts’ readiness to accept the First Amendment defence appears to be on the wane,<sup>266</sup> however. In *Abu Dhabi Commercial Bank v. Morgan Stanley & Company, Incorporated*,<sup>267</sup> the court rejected the First Amendment defence on three main grounds: (i) the narrowness of the distribution of the rating in question, (ii) the rating agency’s state of mind and knowledge, and (iii) evident conflicts of interest.<sup>268</sup> Based on this recent decision, it therefore appears that US courts will not uphold a First Amendment defence where the distribution audience is limited, where the rating agency knows that its ratings are misleading, and where there are conflicts of interest (for example, in the common case where the rating agency plays a role in the structuring of the actual product it is then paid to rate).<sup>269</sup> Furthermore, up until the passage of *Dodd-Frank Wall Street Reform and Consumer Protection Act*,<sup>270</sup> ratings agencies were generally exempt from liability under Section 11 of the United States *Securities Act of 1933*.<sup>271</sup> Notwithstanding the success or failure of any pre-emptive defences, rating agency liability for pure economic loss in tort law will ordinarily be founded on several bases.<sup>272</sup> These include negligent misrepresentation, product liability, tortious

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<sup>263</sup> Edwards op cit note 39 at 188.

<sup>264</sup> Blumberg, Wirth & Litsoukov op cit note 12 at 35.

<sup>265</sup> *New York Times v Sullivan* 376 U.S. 254 (1964).

<sup>266</sup> Blumberg, Wirth & Litsoukov op cit note 12 at 35.

<sup>267</sup> 2009 WL 3346674 (S.D.N.Y., Oct. 15, 2009).

<sup>268</sup> Ellis, Fairchild & D’Souza op cit note 7 at 190.

<sup>269</sup> Ellis, Fairchild & D’Souza op cit note 7 at 192.

<sup>270</sup> Pub.L. 111–203, H.R. 4173.

<sup>271</sup> 15 U.S.C. § 77a.

<sup>272</sup> Gary Schwartz ‘American tort law and the (supposed) economic loss rule’ in Bussani & Palmer (eds) *Pure economic loss in Europe* 2 ed 2003 94 at 95.

interference and arguably breach of a professional care standard,<sup>273</sup> each of which will be considered briefly in turn.

It has been argued that in a claim for negligent misrepresentation courts will apply very similar standards to the ones applied against auditors in similar claims, despite the differences between the two types of defendant.<sup>274</sup> It is submitted that the most important of these is Section 552 of the Restatement (Second) of Torts, which gives rise to liability to investors where their reliance on a ratings agency's reports is foreseeable.<sup>275</sup> Given that this is almost always the case (ratings agencies certainly know their ratings are used and relied upon), this is a compelling ground for liability.

Second, it may also be argued that product liability should be extended to intangible consumer credit products, including credit ratings.<sup>276</sup> This is arguably more of a stretch, however, because an investor would need to prove that ratings (as distinct from the debt securities they rate) amount to intangible products themselves, that they were defective at the time of their issue, that investors were foreseeable users of those products and that investors were harmed by those products. This burden remains thus far unproven in US courts and it remains open to attack on the grounds that ratings are opinions, not products, and that at the time of their issue they cannot be defective because they are necessarily predictive and not reactive. One can imagine that the ratings agencies might argue, "no one predicted the financial crisis!" Nonetheless, this remains an interesting, novel ground for tortious liability.

Third, tortious interference with contracts is also a possible ground for liability if it can be shown that an unsolicited negative rating prevents a debt issuer from accessing capital and thereby interferes with prospective contracts. However, in *Jefferson County School District v. Moody's Investor Services, Incorporated*<sup>277</sup> the court was not persuaded by similar arguments, even in the case of a CRA defendant.

Fourth, is there a ratings agency standard of professional care in US law? One case in particular, *Mallinckrodt Chemical Works v. Goldman, Sachs & Co.*<sup>278</sup>

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<sup>273</sup> GPV 'Liability for misstatements by credit-rating agencies' (1957) 43(4) *Virginia Law Review* 561 at 574.

<sup>274</sup> Blumberg, Wirth & Litsoukov op cit note 12 at 36. See also in this regard note 21 infra.

<sup>275</sup> Blumberg, Wirth & Litsoukov op cit note 12.

<sup>276</sup> Blumberg, Wirth & Litsoukov op cit note 12.

<sup>277</sup> 175 F.3d 848, 856 (10<sup>th</sup> Cir. 1999).

<sup>278</sup> 420 F. Supp. 231 (S.D.N.Y. 1976).

leaves open the possibility that there might be. The facts were very similar to *Bathurst* but the claimants founded their action on breaches of US Securities Laws in the first instance and only on negligence in the alternative. Accordingly there was never a need for the court to lay down the standard of care expected of credit rating agencies because the case was resolved under the Securities Laws. Notwithstanding this failure to define the standard of care owed by a ratings agency to investors on highly appropriate facts, it remains possible that a US court might do so in the future, particularly in light of the general shift in legislators' attitudes. This shift is evidenced by the drive to increased regulation and accountability of financial intermediaries under laws like *Dodd-Frank*.

One case that is currently working its way through the courts, and representative of many others like it, is *California Public Employees' Retirement System v Moody's* (CALPERS).<sup>279</sup> Developments in this case are being watched very closely the legal fraternity who are hoping it will provide much needed clarity with regards to exactly what is required for a ratings agency to incur liability for negligent misrepresentation.<sup>280</sup> The plaintiffs in CALPERS have successfully overcome the initial hurdle of the defendant's motion to dismiss on the basis of First Amendment protection. The claimants had invested \$1.3 billion worth of government employee pension funds in AAA-rated structured finance assets that collapsed as the global financial dislocation took hold in 2007 and 2008. They accordingly sued Moody's for negligent misrepresentation and "negligent interference with prospective economic advantage",<sup>281</sup> arguing three major points: (i) that Moody's rating models were flawed because they did not factor in problems with liquidation of the underlying assets, (ii) the models did not account for the high geographical concentration of the assets, and (iii) the data that was used as inputs was data that Moody's other faulty models had provided.<sup>282</sup> It has been argued compellingly that the facts of this case will meet the threshold implied by the three *Abu Dhabi* factors mentioned above, and that when this decision is handed down it will establish that rating agencies face common law liability for lapses in the lead in to the global

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<sup>279</sup> Ellis, Fairchild & D'Souza op cite note 7 at 205.

<sup>280</sup> Ibid.

<sup>281</sup> Ibid.

<sup>282</sup> Ibid.

financial crisis.<sup>283</sup> This will, in all likelihood, lead to massive claims in the US, especially given the friendliness of that legal system to class actions.



"I know nothing about the subject,  
but I'm happy to give you my expert opinion."

Figure 7

## 7. Civil liability and *caveat emptor*: a death knell?

It is not controversial to say that credit ratings are pervasive in modern capital markets, and further that they play a significant part in the evaluation of financial institutions' balance sheets with regards to regulatory capital requirements.<sup>284</sup> It is also clear that financial markets had become overly reliant on credit ratings in the run up to the financial crisis.<sup>285</sup> One of the unintended consequences of a civil liability regime for credit ratings agencies is that investors are incentivised to be less thorough in their own assessments of credit risk, quite possibly to the extent that they might take decisions in reliance on ratings that they would ordinarily not have.<sup>286</sup> "After all," opportunistic investors might say, "even if we're wrong, S&P gave that debt security a rating of AAA, so if our investment fails we can just sue them!" With this kind of problem in mind, it has been a key objective of both governments and

<sup>283</sup> Ibid.

<sup>284</sup> Edwards op cite note 39 at 186.

<sup>285</sup> Ibid.

<sup>286</sup> Johansson op cit note 29 at 18.

financial supervisory bodies (for example the Basel Committee on Banking Supervision (BCBS)) in the aftermath of the financial crisis to reduce the reliance placed by financial market participants on credit ratings.<sup>287</sup> The core idea is that ratings should, at the most, support ordinary investor due diligence, but never replace it.<sup>288</sup>

How should governments give effect to this idea? The overtures from the EU in the form of CRA 3 are both progressive and particularly illuminating in this regard. Over and above the Article 35a civil liability regime discussed above,<sup>289</sup> CRA 3 also attempts to moderate two types of investor behaviour: (i) investors outsourcing their credit assessment responsibilities, and (ii) a mechanistic, unthinking application of investment fund parameters. The first behaviour described in (i) is problematic because it can contribute to investors placing exclusive reliance on credit ratings to the exclusion of their own judgement, thereby purporting to divest themselves of any duty to conduct the required due diligence. The EU's response to this kind of behaviour is Article 5a that requires that potential investors "shall make their own assessment and shall not solely or mechanistically rely on credit ratings for assessing the creditworthiness of an entity or a financial instrument".<sup>290</sup> This is an important barrier against frivolous lawsuits that a lenient approach to Article 35a might otherwise encourage.<sup>291</sup>

The second behaviour which the Regulations are alive to is the so-called "cliff effect", where a kind of herd mentality on the part of investors can force a collective sell decision in respect of a particular debt security. This can occur when the mechanical application of investment criteria means that a ratings downgrade causes a debt security to no longer be eligible to form part of an investment fund.<sup>292</sup> This phenomenon is problematic because it can exaggerate the impact of a downgrade if a high number of securities owners are automatically compelled to sell a particular security without the application of any discretion. Again, the core

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<sup>287</sup> Ibid.

<sup>288</sup> See e.g. the Basel Committee on Banking Supervision, 'Strengthening the Resilience of the Banking Sector' (2009) *Consultative Document* available at <http://www.bis.org/publ/bcbs164.htm> accessed 24 May 2012.

<sup>289</sup> See 6.2 *infra*.

<sup>290</sup> Regulation (EC) No 1060/2009 (as amended), Art 5a.

<sup>291</sup> See 6.2 *infra*.

<sup>292</sup> Edwards *op cit* note 39 at 186.

problem is a failure on the part of investors to apply their minds to a particular investment decision, but because the outcomes are potentially different, the response to this problem is different, too. In this regard, Article 5c gestures towards a proposed regulatory framework for institutional funds that explicitly removes any references to credit ratings in EC legislation which might trigger exclusive, unthinking reliance on credit ratings.<sup>293</sup> However, the stipulated timeframe by when this legislation must be passed is 2020, so there is a period of limbo yet.<sup>294</sup> The question of what might eventually replace credit ratings remains unanswered. It has been argued that it will likely be unacceptable for financial institutions to attempt to perform all credit assessments in-house, and that any substitutes for credit ratings will inherently suffer the same defects that befall credit ratings themselves.<sup>295</sup> Whatever the outcome, the European authorities have yet to treat any of the possible replacement suggestions with any seriousness.<sup>296</sup>

Locally, it is not yet clear what the South African legislature's move will be in this regard. Given that the delictual regime envisaged by the Act arguably sets a higher bar than what is contemplated under CRA 3's Article 35a, it is debateable whether or not the behaviours described above will ever be problematic in the South African context. This is because a local plaintiff would arguably need to do more work in proving the wrongfulness element of a delict (which requires demonstrating the reasonableness of reliance), thus perhaps problems of opportunistic litigation are less relevant.

## 8. Conclusion

The global financial crisis animated very vividly the extent to which the fortunes of countries and their people are intertwined with a financial system that is notorious for its opacity. This is especially true when we consider the extent to which global economic growth has been slowed (and indeed, in many cases reversed) in recent

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<sup>293</sup> See, for example, the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive 2009/65/EC and the European Securities and Markets Authority "Guidelines on a common definition of European money market funds" 19 May 2010, available at <http://www.esma.europa.eu/content/Guidelines-Common-definition-European-money-market-funds>, accessed on 20 November 2013.

<sup>294</sup> Regulation (EC) No 1060/2009 (as amended), Art 5c.

<sup>295</sup> Edwards op cite note 39 at 187.

<sup>296</sup> Edwards op cite note 39 at note 8 suggests that neither of the serious contenders (the Covered Bond Label and the Prime Collateralised Securities schemes) have received any market traction.

times as a direct consequence of the financial crisis. In this dissertation I have attempted to clarify how properly functioning credit rating agencies might contribute to the efficient operation of capital markets. It should be clear that if ratings agencies observe uncompromisingly high standards of care at all times, they can be a highly beneficial addition to the welfare and efficiency of a capital market. But if they do not observe those standards of care, the modern technologies that permit the interconnectedness of capital markets mean that the dire consequences of negligently misrating a debt security are not confined to geographical borders. In response to these kinds of problems, many countries are taking the step of moving towards a civil liability regime for ratings agencies as a deterrent against reckless behaviour. It is submitted that with regard to this narrower question of the application of a civil liability standard, four tentative conclusions are uncontroversial.

First, it is highly debatable whether the spectre of extensive civil liability will compel ratings agencies to meet requisite standards of care in performing their gatekeeping function, or whether it will simply drive up costs for all market participants and contribute to a decrease in competition in the ratings industry, which is already characterised by highly entrenched oligopolies. It is also debatable whether there is any wisdom in designing a system of liability that can be said to remove the incentives that should motivate investors to conduct their own credit risk evaluations and due diligence in accordance with the fundamental principle of *caveat emptor*.<sup>297</sup> That being said, this is the path that our legislature has started down. Prospective litigants will be required to grapple with in the principles of delict examined in this dissertation in weighing the merits of their cases.

Second, the common law jurisdictions of Australia, the UK and the US each permit actions against ratings agencies for negligence in the composition of their ratings, but each country does so via subtly divergent means. Accordingly, the conclusion that governments everywhere are seeking to use civil liability as a deterrent against shoddy professional practices is inescapable. I have attempted to show in this dissertation that one can make a case that the novel findings of the Federal Court of Australia in *Bathurst* can be replicated with some success in a court

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<sup>297</sup> Edwards op cite note 39 at 191. Also see Hamblen J in *Cassa di Risparmio della Repubblica di San Marino v Barclays Bank* [2011] EWHC 484 (Comm) at para 265.

in South Africa, provided the right facts persuade a judge on the crucial element of wrongfulness. Furthermore, given our legal system's tangled history, lessons from the common law jurisdictions of England and the United States will almost certainly guide our own courts in reaching their decision when this issue is litigated. This is most obviously true with regards to wrongfulness in light of persuasive authorities that deal with the analogous 'duty of care' concept. Disappointed investors who are on the hunt for a defendant would be wise to become familiar with the application of these factors before embarking on the costly road of court action that carries with it the possibility of an adverse finding of contributory negligence.

Third, in light of the fact that the suggested basis for liability in England in fact emanates from Europe, and that as described in this paper the G-20 members have nearly all recently enacted similar legislation, the days of soaring profits for credit rating agencies—which sometimes come at the expense of accuracy and independence—are arguably numbered. Whether this is a good thing for capital market efficiency or credit rating agency integrity (or both) remains to be seen. Some academics have suggested that in the event that civil liability proves to be an over-deterrent that results in a 'market freeze', whereby the agencies are excessively hesitant to provide any ratings at all, a kind of 'cap' on liability should be introduced so as to give some comfort to the rating agencies who might be faced with suits for pure economic loss.<sup>298</sup> But given that the suggestions for capped liability almost always emanate from civil law jurisdictions it is debateable whether our legislature would follow suit and thereby be seen to trespass in the realm of delictual damages normally which is presided over by judges.

Finally, and related to the preceding point, when the first of these cases reaches a judge in South Africa, the wrongfulness element of delictual liability for this 'new' type of pure economic loss should, as always, be approached with abundant caution. Our courts are fortunate to have a large body of pure economic loss jurisprudence to draw from. Because of this, provided ample attention is given to how the wrongfulness factors in analogous cases might be transposed onto the case of a credit rating agency, the first case will be absolutely critical in establishing what kinds of behaviours and circumstances might attract liability and what will not.

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<sup>298</sup> Haar op cit note 257 at 23; Scarso op cite note 24 at 164.

All governments are trying to determine how best to insulate themselves against the effects of a future financial crisis and most have taken steps to regulate the ratings agency industry. In the context of South Africa, the Credit Ratings Service Act is our legislature's first foray into the murky waters of regulating ratings agencies. It is quite likely, however, that in the event that the first court decisions in terms of Section 19 of the Act are perceived to be investor friendly to the extent that they trigger frivolous and opportunistic litigation, that it will not be the last.



**Figure 8**

*(Translation: "My God – his latest judgement!")*

*"Even worse – that's a Moody's thumb!")*

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