

# The Debt Ratings Debate and China's Emerging Credit Rating Industry: Regulatory Issues and Practices

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*Credit Rating Agencies (CRAs) have been regarded as one of the industries which are account for the global economic downturn. The “Debt Ratings Debate” after the subprime crisis of 2007 discussed the effectiveness of the credit rating system and raised questions in practice. Accompanying the boom and deregulation of the bond market over the last decade, China’s emerging credit rating industry has entered a stage of rapid growth. This paper seeks to review legal issues of China’s credit rating agencies (CRAs) from the perspective of comparative study. Part I gives an overview of two main stages in the development of this emerging industry. Part II and Part III examine major issues in the debt ratings debate, such as conflict of interests, enhancing competition and regulatory reform. Part II first compares the advantages and disadvantages of various pay models for CRAs, including the dominant issuer pays model and alternative pay models; then it discusses how regulation affects competition and business activities of credit rating agencies and related regulatory reform in the U.S. and EU. Part III examines the barriers, and cause of action concerning the CRA liability through some significant cases, such as County of Orange v. McGraw Hill Cos, Jefferson Cty. Sch. Dist. No. R-1 v. Moody’s Investors, Inc., and Abu Dhabi Comm. Bank v. Morgan Stanley & Co. in the U.S. Part IV reviews the practices of four major Chinese CRAs. Part V examines the multiple regulatory system and two self-regulatory organizations for credit rating industry. Part VI discusses a series of legal issues in the Chinese context, such as the current issuer pays model and conflicts of interest, reputational mechanism, rating shopping, market access, independence of CRAs and accountability of credit rating agencies, as well as a recent case concerning the credit rating of a peer-to-peer lending platform. Finally, it concludes that the financial system reform and forthcoming structure reform may change the multi-regulator system.*

**Keywords:** Credit Rating Agency (CRA); Issuer Pays Model; Investor Pays Model; Rating Shopping; CRA Liability

## Introduction: China’s Emerging Credit Rating Industry

The emergence of China’s credit rating industry has experienced a few stages. The earliest stage developed slowly. In February 1988, Shanghai Fareast Credit Rating Co., Ltd. was founded as the first credit rating agency with the approval of the PBoC Shanghai Branch.<sup>1</sup> The State Economic and Trade Commission and PBoC approved the establishment of China Chengxin and Dagong Global in 1992

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<sup>1</sup>Dagong Global, “The Brief History of China’s Credit Rating Industry”, <http://en.dagongcredit.com>

and 1994 respectively. In 1997, the PBoC accredited nine CRAs the qualification of national credit ratings.<sup>2</sup> In 1999, China Chengxin International Credit Rating Co., Ltd. became the first joint-venture CRA in China. In the 1990s, a few CRAs such as the China Lianhe Credit Rating Co., Ltd., China Chengxin International Credit Rating Co. Ltd., Dagong Global Credit Rating Co., Ltd., Shanghai Brilliance Credit Rating & Investors Service Co., Ltd., and Pengyuan Credit Rating Co., Ltd. were founded. After 2005, their business made substantial progress accompanying the boom and deregulation of bond markets. In January 2019, S&P became the first foreign CRA to be permitted to provide credit rating services via a wholly own company in China.<sup>3</sup> China promised to open the market for foreign CRAs in two years. On July 20, 2019, the State Council's Financial Stability and Development Committee issued "Relevant Measures Concerning Further Expansion of External Opening of the Financial Sector", allowing foreign CRAs to rate all types of bonds.

### *Early Stage of Credit Rating Industry and Segmented Bond Markets*

The growth of China's credit rating industry keeps pace with the development of China's bond market. In March 1987, the State Council enacted the *Interim Regulation on Administration of Enterprise Bonds*, which established the issuance and administration system for state-owned enterprises (SOEs) to issue enterprise bonds. The 1987 regulation stipulates that People's Bank of China (PBoC), Ministry of Finance (MOF) and the State Planning Office shall work out the annual quota of enterprise bond issues on a national scale and proceed at the province level.<sup>4</sup> In 1993, the State Council enacted the *Regulation on Administration of Enterprise Bonds* to promote the enterprise bond market. The 1993 Regulation solidified the approval system and the PBoC, MOF, State Planning Office and the State Council Securities Commission formulated the inaugural annual quota for issuing enterprise bonds.<sup>5</sup>

The allocation system for approved bond issues decided by the State Council in 1992 is as follows: (a) The Ministry of Finance is in charge of government bonds; (b) The PBoC approves financial bonds and investment securities bonds; (c) The State Planning Office approves state investment bonds and state investment corporate bonds; (d) The PBoC and the State Planning Office approve central state-owned enterprise bonds; (e) Local government bonds are approved by the provincial governments or governments of cities specifically designated in the state plan.<sup>6</sup> The framework of separate operation and separate regulatory system produced the following two bond markets:

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<sup>2</sup>Circular of PBoC *Yin Fa* [1997] No. 547.

<sup>3</sup>S&P Global (2019).

<sup>4</sup>Article 12 of the *Interim Regulations on Administration of Enterprise Bonds* issued by the State Council on March 27, 1987 and replaced by the *Regulations on Administration of Enterprise Bonds* on August 2, 1993.

<sup>5</sup>Articles 10 and 11 of the *Regulations on Administration of Enterprise Bonds* issued by the State Council on August 2, 1993 and amended on January 8, 2011.

<sup>6</sup>Article 2.2 of the *Notification on Further Strengthening Macro-economic Management of Securities Market* issued by the State Council on December 17, 1992.

	<b>Inter-bank Bond Market</b>	<b>Exchange Bond Market</b>
Market Participants	Commercial banks are the major market player; Other participants include non-bank financial institutions, enterprises and public institutions. Not open to individual investors	Non-bank financial institutions, non-financial institutions and individual investors.
Traded Bonds	Government bonds; Enterprise bonds; <sup>7</sup> Policy financial bonds; Central bank bills; <sup>8</sup> commercial paper; <sup>9</sup> Medium-term notes <sup>10</sup>	Government bonds; Enterprise bonds; Corporate bonds <sup>11</sup>
Self-regulatory Organization	National Association of Financial Market Institutional Investors (NAFMII)	Securities Association of China (SAC)
Regulator	The People's Bank of China (PBoC)	China Securities Regulatory Commission
Yield Rate of Bonds	Relatively low yields	High yields
Liquidity	With higher market liquidity	With lower liquidity ratio

In the mid-1990s, enterprise bond default rates continuously rose. By the end of 1997 default risks piled up to nearly CNY 3 billion; in Liaoning Province and Jilin Province the default rate rose above 50%.<sup>12</sup> In 1998, the PBoC required that enterprises should provide guarantees when issuing bonds, except those approved by the PBoC for exemption.<sup>13</sup>

Meanwhile, the government took measures to solve the credit default problem. The issuers were required to provide commercial bank guarantees. In

<sup>7</sup>The issuance of enterprise bonds is approved by the NDRC. "Enterprise bonds" refer to "the negotiable securities issued by enterprises in accordance with legal procedures, and on which such enterprises agreed to pay principals and interests within a certain period." See Article 5 of the *Administrative Regulations on Enterprise Bonds* issued by the State Council on August 2, 1993 and amended in 2011.

<sup>8</sup>Central bank bills are issued based upon the *Interim Measures of the PBoC for the Administration of Financial Bills* (1993).

<sup>9</sup>"Commercial paper" refers to "the debt financing instrument agreed to repay principal and interest within one year issued by non-financial enterprises (hereinafter referred to as the enterprises) with legal person qualification in the inter-bank bond market". See Article 2 of the *Guidelines by NAFMII* (15 April 2008).

<sup>10</sup>"Medium-term notes" refer to "debt financing instruments agreed to repay principal and interest in a certain term issued by phases according to the plan by non-financial enterprises (hereinafter referred to as the enterprises) with legal person qualification in the inter-bank bond market". See Article 2 of the *Guidelines by NAFMII* (16 April, 2008).

<sup>11</sup>The issuance of corporate bonds is approved by the CSRC. "Corporate bonds" refer to "marketable securities issued by a company pursuant to statutory procedures whose principal plus interest shall be serviced within a specific time limit as agreed upon". See Article 153 of the *PRC Company Law* (2014 amendment).

<sup>12</sup>Tao (2014).

<sup>13</sup>Article 3 of the *Administration of Issuance and Transfer of Enterprise Bonds* issued by PBoC on April 1, 1998 and nullified on August 17, 2000.

June 2004, the PBoC issued a regulation directing towards the inter-bank bond market. This allowed commercial banks to hold subordinated bonds issued by other banks capped at 20% of their core capital.<sup>14</sup> In 2003, the NDRC took the place of the State Development and Planning Committee<sup>15</sup> in the administration of enterprise bond issues. As a result of the strict approval system and “rigid redemption”, the default risk from 1998 to 2006 dropped to a more acceptably low rate.<sup>16</sup> From 2001 to 2004, Chinese CRAs only issued ratings for 60 bonds, whose issue volume was less than CNY 150 billion.<sup>17</sup> Therefore, during that timeframe there was a limited market for credit ratings.

#### *Rapid Development after 2005*

The year of 2005 is an important turning point for both the Chinese credit rating industry and bond market. The turning point occurred when the NDRC decided to boost the enterprise bond market. Later, the emergence and rapid development of Subordinated debts of Commercial banks, non-policy financial bonds, commercial paper, asset-backed securities and medium-term notes, greatly boosted the inter-bank bond market and the exchange market, thus promoting a continued progression of the credit rating industry.

In May 2005, the PBoC allowed qualified financial institutions to underwrite and/or trade short-term financing bonds in the National Inter-bank Bond Market under an agreement.<sup>18</sup> In 2005, 79 short-term financing bonds were issued and the volume reached CNY 142.4 billion. From 2005 to 2012, the emergence of a large number of short-term financial bonds, commercial paper and medium-term notes (MTNs) promoted the credit rating industry; Chinese CRAs issued ratings for 6,155 bonds, of which short-term financial bonds and medium-term notes occupied 62.15%.<sup>19</sup>

In 2008, the NDRC enacted NDRC Finance [2008] No. 7, which allowed enterprises to issue unsecured bonds, asset-backed bonds and third-party secured bonds.<sup>20</sup> Considering the risk of off-balance sheet manipulation, the CBRC required commercial banks to gradually withdraw from project-based enterprise bond issue guarantees while simultaneously eliminating their ability to provide guarantees on new bond issues. After 2008, the NDRC no longer required financial guarantee for enterprise bond issues. Thereafter, the proportion of

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<sup>14</sup>Article 13 of the *Rules on the Issuance of Subordinated Bonds by Commercial Banks* issued by PBoC on June 17, 2004.

<sup>15</sup>The State Planning Office became the State Development and Planning Commission in 1998 in the restructuring of the State Council. In the 2003 restructuring of the State Council, the National Development and Reform Commission (NDRC) took the place of the State Development and Planning Committee together with the previous State Economic Restructuring Office and part functions of the State Economic and Trade Commission.

<sup>16</sup>Lin (2005).

<sup>17</sup>Guo & Zhang (2012) at 14-19.

<sup>18</sup>Articles 2 and 3 of *Operating Procedures for the Underwriting of Short-term Financing Bonds* issued by the PBoC on May 23, 2005 and nullified on April 15, 2008.

<sup>19</sup>Guo & Zhang (2012) at 14-19.

<sup>20</sup>Article 3 of the *Notification on Promoting the Development of Enterprise Bond Market and Simplifying Related Items of Approval-based Issuance Procedure* issued by the NDRC on January 2, 2008.

secured bonds decreased year after year, declining from 19.4% in 2008 to less than 10% in 2013.<sup>21</sup>

In 2011, the Ministry of Finance initiated the pilot self-issue of bonds for local governments of Shanghai municipality, Zhejiang province, Guangdong province and Shenzhen city to implement in 2011, upon the approval of the State Council. The terms of 2011 government bonds were issued in three years and five year, subject to the issue scale approved by the State Council.<sup>22</sup> In 2013, the Ministry of Finance enlarged the scope of “Pilot Provinces (Municipalities)” to Shanghai Municipality, Zhejiang Province, Guangdong Province, Shenzhen City, Jiangsu Province and Shandong Province.<sup>23</sup> In 2019, China bond market has reached USD13 trillion. Yet, debt failures increase too.<sup>24</sup>

The booming bond market after 2005 stimulated the development of credit rating industry. Chinese CRAs sought to cooperate or establish joint ventures with the Big Three: Moody’s owns a 49% share in China ChengXin International Credit Rating Co., Ltd.; Fitch owns 49% of China Lianhe Credit Rating Co., Ltd.; Shanghai Brilliance Credit Rating & Investors Service Co., Ltd also has technical cooperation with Standard & Poor’s. The cooperation with the Big Three and the boom of bond market helped China’s credit rating business enter a stage of stable development. By 2011, the market share of credit rating business among five CRAs in China’s inter-bank bond market and exchange bond market was as follows:<sup>25</sup>

	<b>Dagong Global</b>	<b>China Lianhe</b>	<b>Shanghai Brilliance</b>	<b>China Chengxin</b>	<b>Shenzhen Pengyuan</b>
<b>CPs</b>	17.05%	30.49%	10.66%	35.90%	0.00%
<b>MTNs</b>	22.12%	31.76%	16.00%	30.12%	0.00%
<b>Enterprise Bonds</b>	25.79%	17.89%	11.58%	18.42%	26.32%
<b>C-Bonds</b>	8.70%	22.83%	9.78%	44.57%	14.13%
<b>Financial Bonds</b>	12.12%	45.45%	6.06%	36.36%	0.00%
<b>In Total</b>	19.19%	28.96%	12.30%	32.22%	4.67%

Aside from domestic strategies, Chinese CRAs have pursued internationalization. In December 2003, Shanghai Far East Credit Co. Ltd. (SFECR) joined the ACRAA.<sup>26</sup> Later, five other Chinese CRAs, including China Chengxin, China Lianhe, Dagong Global, Shanghai Brilliance Rating, and Golden Credit Rating International Co., Ltd., have become members of the Association of Credit Rating Agencies in Asia (ACRAA).<sup>27</sup> As of August 13, 2015, four Chinese CRAs--Chengxin, Lianhe, Dagong Global (including Dagong Europe Credit Rating, S.r.l.

<sup>21</sup>Lin (2005).

<sup>22</sup>*Measures for Pilot Self-issue of Bonds by Local Government in 2011* issued by the Ministry of Finance.

<sup>23</sup>*Pilot Measures for Local Governments on Issuing Their Own Debts in 2013* issued by the Ministry of Finance on June 25, 2013.

<sup>24</sup>Bloomberg news (2019).

<sup>25</sup>Zhang (2013) at 76-80. These data are originally from WIND database.

<sup>26</sup>“Filing materials of the Shanghai Far East Credit Rating Co., Ltd.” (November 2005), [www.chinabond.com.cn/Info/812702](http://www.chinabond.com.cn/Info/812702).

<sup>27</sup>ACRAA, <http://acraa.com/acraamembers.asp>.

in Italy), and Shanghai Credit Information Services Co., were recognised by the European Securities and Markets Authority (ESMA).<sup>28</sup>

With regard to credit information database, the PBoC Credit Reference Center (CCRC) was established in 2006 and then registered in Pudong New Area, Shanghai in 2008. In 2014, the Chinese government announced the plan to establish a social credit system covering financial, economic, and socio-political responsibility in line with China's social control.<sup>29</sup> In 2015, the Chinese government launched pilot programs in consumer credit reporting. Eight technology companies, including Alibaba's Sesame Credit, Tencent Credit, Ping An's Qianhai Credit, Kaola Credit (for P2P online lending), Pengyuan Credit, China Chengxin Credit, Qianhai Credit Service, and IntelliCredit, Sinoway Credit, participated in the pilot program and provided data and technology support. Thereafter, the PBoC realized the "credit leap forward" through collection of sharing eight firms' consumer data. As a result, the Baihang Credit—China's first unified personal credit information firm" was launched on March 23, 2018.<sup>30</sup> In 2019, CCRC has covered credit information of 990,000,000 individuals as well as 25.92 million enterprises and other entities.<sup>31</sup> It is noted that the CCRC system is a mixture of economic criteria and non-economic criteria and it can be used to punish offenders on the certain blacklists. This is a much broader range of usage of the social credit system compared with other countries which generally limits to financial measures of creditworthiness.<sup>32</sup>

### **The Debt Ratings Debate and Related Regulatory Reform on CRAs**

Inadequate or incorrect ratings by the CRAs produced significant losses and were a substantial component of the 2008 global financial crisis. The "Debt Ratings Debate" mainly focuses on conflict of interest arising from the issuer pays model, reputational mechanism, accountability of credit ratings, and CRAs' liability of false ratings.

#### *The Debt Ratings Debate*

The debt ratings debate after the subprime crisis of 2007 discussed the effectiveness of the credit rating system and raised questions such as whether the failure of ratings had been "a result of a potential conflict of interest and/or a lack of competition in the industry".<sup>33</sup> The *Dodd-Frank Wall Street Reform and Consumer Protection Act*, covered CRA reform.<sup>34</sup> Due to significant conflicts of

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<sup>28</sup>Wikirating (2015).

<sup>29</sup>*Notice of the People's Bank of China on Issuing the Industry Standards on Standards of User Management in Basic Financial Credit Information Database* issued on November 2, 2014.

<sup>30</sup>Koetse (2018).

<sup>31</sup>PBoC (2019).

<sup>32</sup>Mercator Institute for China Studies (2017).

<sup>33</sup>Henderson (2008).

<sup>34</sup>*Dodd-Frank Act*, Pub. L. No. 111–203, 124 Stat. 1872–90 (2010) (enacting "Subtitle C—Improvements to the Regulation of Credit Rating Agencies", §§ 931–939H of the Dodd-Frank bill).

interest that exist in the issuer pays model, alternative payment models were proposed for consideration as stated in the following table.

<b>Pay Models</b>	<b>Advantages</b>	<b>Disadvantages</b>
<b><u>Issuer Pays Model</u></b> Securities issuer pays the credit rating	Widely used since 1970s; Ensures ratings available to the entire bond market	Resulted in conflicts of interest; CRAs may compromise on profits at the cost of quality of ratings
<b><u>Investor Pays Model</u></b> Investors or subscribers pay the credit rating	CRAs feel independent of issuers; Partly avoids problems of conflicts of interest;	Increases the cost of investment risked and thus reduces demand for securities; Reduces the independence of CRAs
<b><u>“Payment-upon-Results” Model</u></b> CRAs’ payment depends on the accuracy of ratings	This model “could hold CRAs more accountable for the quality of their ratings”. <sup>35</sup>	Hard to implement this model
<b><u>Public Utility Model</u></b> This model suggests to establish a government managed CRA. <sup>36</sup>	Using the results of public CRA to check credit ratings issued by private CRAs	Concerns about expense; Increasing overreliance on rating results
<b><u>“Trading venues Pay” Model</u></b> A joint model for issuer pays model and investor pays model	This alternative accommodates both the issuer pays model and subscriber/investor pays model	Not covers large number of unlisted securities; Not favoured by market participants and public authorities
<b><u>Hiring Agent Model</u></b> A public or private utility or a SRO assigns NRSROs to determine the debt ratings.	This model tries to introduce a third-party agent to solve the problem of conflicts of interest	Concerns about costs; Hard to operate
<b><u>Blind, Pooled Issuer-Pay Model</u></b> This model requires issuers to pool the payments and let an independent third-party assign a CRA to rate the issuer’s security. <sup>37</sup>	This model may solve problems of free rider, conflict of interest, and competition. <sup>38</sup>	Considering their limited number, CRAs may act as a whole and still favour issuers over investors in issuing ratings; May lead to more “homogenised”. <sup>39</sup>

The debt ratings debate has highlighted that the role of CRAs going forward is far from certain. Despite all of the outcry over the problems plaguing CRAs, clear

<sup>35</sup>Garcia Alcubilla & Ruiz Del Pozo (2012) at 251.

<sup>36</sup>European Commission (2010).

<sup>37</sup>Senator Al Franken (D-Minn.), who introduced such a proposal as an amendment to the Senate version of the Dodd-Frank Act, called for the creation of a Credit Rating Agency Board to serve as a central clearinghouse for issuer’s seeking ratings. He argued that this proposal eliminates many of the conflict of interest concerns.

<sup>38</sup>The *Dodd-Frank Wall Street Reform Act* requires the SEC to evaluate such a proposal, in conjunction with a Government Accountability Office study, and to accordingly enact regulations creating a Credit Rating Agency Board to serve as a central clearinghouse for issuer’s seeking ratings, unless the study suggests alternative action. See *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111–203, 124 Stat. 1887–88 (2010) (§§ 939D–939F).

<sup>39</sup>Drawbaugh & Sullivan (2010).

solutions do not exist. There still do not appear to be any substantially viable solutions to resolving conflicts of interest that would not create additional problems or conflicts.

### *Post-crisis Ratings Reform in the United States*

An examination of the existing regulations concerning the liability of CRAs makes it apparent that deregulation is an unlikely policy choice. Prior to the subprime crisis, CRAs were treated leniently. For example, CRAs are exempted from Regulation FD. Before 2009, Rule 436(g) exempted Nationally Recognised Statistical Ratings Organizations (NRSROs) from liability if they knowingly made false or misleading statements related to securities registration, although non-NRSRO CRAs were legally liable for their statements. On July 22, 2010, the *Dodd-Frank Act* nullified SEC Rule 436(g) and thus imposed Securities Act Section 11 liability on rating agencies. Section 939A of the *Dodd-Frank Act* requires all federal agencies, within one year of passage, to end regulatory agency reliance on credit ratings and replace such references with alternative criteria that evaluate the credit-worthiness of an issuance. In the wake of the *Dodd-Frank Act's* changes, the SEC announced the end of the Regulation FD exemption for CRAs, which took effect on October 4, 2010.<sup>40</sup> However, as of March 16, 2011, members of the Capital Markets Subcommittee of the House Financial Services Committee introduced a few bills designed to repeal Section 939A of the *Dodd-Frank Act*.<sup>41</sup> As a result, whether and how to impose liability on CRAs for their ratings is debatable.

### *Regulatory Reform in the European Union*

In Europe, the European Commission's *Public Consultation on Credit Rating Agencies* examined the overreliance on external credit ratings, enhancing competition in the credit rating industry, potential conflicts of interest arising from the "issuer-pays" model, and the civil liability of CRAs.<sup>42</sup> EC 1008/2009 addresses the independence and integrity of CRAs (long-lasting relationships between CRAs and rated entities). For example, Article 6a "Conflicts of Interest Concerning Investing in CRAs" requires a shareholder or a member of a CRA holding at least 5% shares or voting right in that CRA or in a company which has control rights over that CRA shall avoid conflict of interest under certain circumstances.<sup>43</sup>

In addition, Article 35a of EC 1008/2009 stipulates a CRA is liable for any intentional infringements or gross negligence listed in Annex III which has an impact on a credit rating.<sup>44</sup> The proof of evidence of an infringement is generally

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<sup>40</sup>SEC Removal from Regulation FD of the Exemption for Credit Rating Agencies, 17 C.F.R. § 243 (2010).

<sup>41</sup>Kohl (2011).

<sup>42</sup>European Commission (2010).

<sup>43</sup>Article 6a Item 1 of the *Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies*.

<sup>44</sup>Title IIIA, Article 35a "Civil Liability", Item 1 of EC 1008/2009.



on the investor or issuer who claims for damages of the infringement from a CRA.<sup>45</sup>

### *IOSCO Code of Conduct for CRAs*

The International Organization of Securities Commissions (IOSCO) issued *Principles Regarding the Activities of Credit Rating Agency* in September 2003 and *Code of Conduct Fundamentals for Credit Rating Agencies* in March 2015. The IOSCO CRA Principles propose four objectives for CRAs, regulators, rated entities and other market players: (i) quality and integrity of the credit rating process; (ii) independence and conflicts of interest; (iii) transparency and timeliness of ratings disclosure; (iv) confidential information.<sup>46</sup>

### *Type 10 of Financial Services License in Hong Kong*

Under the CAP 571 Securities and Futures Ordinance, the Securities and Futures Commission (SFC) started to implement licensing of credit rating agencies and their rating analysts on June 1, 2011. The SFC issued license of Type 10 (providing credit rating services) to Moody's, S&P, Fitch, A.M. Best Asia-Pacific and CTRISKS in 2011. In June 2012, China Chengxin (Asia Pacific) Credit Ratings Company Limited obtained the license of providing credit rating services (Type 10) granted by the Securities and Futures Commission (SFC) in Hong Kong and became the first overseas CRA of Mainland China.<sup>47</sup>

## **CRA Liability: Perspective of Case Law**

### *Arguments for and against CRA Liability*

Prior to the 2008 crisis, NRSROs were generally immune from civil liability or compensation either for misrepresentation as an expert under Section 11 of the *1933 Securities Act* or for fraudulent liability under 10(b)-5 of the *1934 Exchange Act*. In those few lawsuits against CRAs, such as *Washington Pub. Power Supply System* (1983),<sup>48</sup> *Executive Life Bankruptcy* (1991),<sup>49</sup> *Jefferson Cty. Colo. Sch. Dist. v. Moody's* (1995),<sup>50</sup> and *Newby v. Enron Corp.* (2005),<sup>51</sup> plaintiffs failed in suing CRAs for professional negligence or fraud.<sup>52</sup> However, the aftermath of the subprime crisis greatly challenged the role of CRAs and thus triggered the debate over CRAs' liability.

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<sup>45</sup>Ibid, Item 2.

<sup>46</sup>IOSCO (2003).

<sup>47</sup>China Chengxin (HK), [www.ccxap.com](http://www.ccxap.com).

<sup>48</sup>666 P.2d. 329 (1983).

<sup>49</sup>942 F.2d 1457 (9th Cir. 1991).

<sup>50</sup>988 F. Supp. 1341 (D.C. Colo. 1999).

<sup>51</sup>302 F.3d 295 (5th Cir. 2002).

<sup>52</sup>Partnoy (2009).

The disagreements focused on CRAs' role as either "toolmaker" or "gatekeeper", whether to apply fraud liability in "hostile ratings,"<sup>53</sup> and whether to establish corresponding conduct business rules as well. CRAs argue that they should be treated as "toolmakers" and stress credit ratings as a "predictive opinion" rather than an opinion of result.<sup>54</sup> The "gatekeeper" perspective subjects CRAs to liability for issuers' wrongdoing.<sup>55</sup> Additionally, CRAs regarded ratings as predictive judgments, which are model-driven in the structured-finance context and the model methodology itself is subjective judgment.<sup>56</sup> Rule 436(g) exempted NRSROs from Section 11 liability for misstatements made in securities registration. In 2009, the SEC tried to rescind Rule 436(g). The final disagreement concerns imposing negligence liability, although CRAs historically rely on First Amendment defences to avoid the imposition of liability. In addition to the debate over whether to impose liability, the question of what standard to apply is also widely debated.<sup>57</sup>

#### *Relating Cases in the United States*

The issue of imposing liability on CRAs for their ratings concerns a wide arena of the law: professional negligence, breach of contract, misstatement, violation of antitrust laws, and securities fraud. A review of some significant cases gives an overview of the main issues, barriers, and causes of action concerning CRA liability.

#### *County of Orange v. McGraw Hill Cos.*<sup>58</sup>

In June 1996, Orange County brought a lawsuit for breach of contract and professional negligence against S&P. Orange County contended that S&P inflated its ratings of the County's notes and bonds in 1993 and 1994. Orange County, which suffered a huge financial loss of \$5 billion from its risky investment in derivatives and high-yield bonds, filed for financial bankruptcy in December 1994. S&P, however, claimed that a CRA was protected by the First Amendment and exempted from professional negligence providing that S&P had no "actual malice" in overrating securities issued by the Orange County.<sup>59</sup> The "actual malice" standard, requiring "knowledge that the statement was false or with reckless disregard for whether or not it was true," was applied in this case.<sup>60</sup> Ultimately, the lawsuit was dismissed, and Orange County accepted a nominal sum of \$140,000,

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<sup>53</sup>In the context of CRA treatment, a "gatekeeper" refers to a CRA that is treated as an agent that serves as a check on the compliance of products within the securities market. "Toolmaker" status treats the CRA as an objective specialist in dealing with credit ratings. A "hostile rating" refers to a CRA rating that imposes negative effects on credit ratings.

<sup>54</sup>Deats (2010).

<sup>55</sup>Partnoy (2006).

<sup>56</sup>Hunt (2009).

<sup>57</sup>Ibid.

<sup>58</sup>245 B.R. 151 (C.D. Cal. 1999).

<sup>59</sup>Ibid.

<sup>60</sup>*Hustler Magazine v. Falwell*, 485 U.S. 46, 56 (1988).

which was equal to a partial refund of rating fees paid to S&P by Orange County in 1994.<sup>61</sup>

*Jefferson Cty. Sch. Dist. No. R-1 v. Moody's Investors, Inc.*<sup>62</sup>

In 1993, the Jefferson County School District decided to issue refunding bonds. Although it retained Moody's in the past, the School District chose two other CRAs to rate its bonds and did not provide any financial information to Moody's about this issuance. However, Moody's published its "Rating News" stating that the plaintiff's financial condition was not creditworthy and distributed this "rating" to Moody's subscribers. Moody's uninvited rating negatively affected the plaintiff's bond issuance. The plaintiff, Jefferson County School District, sued Moody's on three counts: (a) intentional interference with contractual and business relations; (b) materially false, misleading and derogatory statement; and (c) violations of the antitrust laws.<sup>63</sup> Like S&P in the Orange County case, Moody's argued for protection of expressions of opinion under the First Amendment;<sup>64</sup> the court deemed this argument sufficient to grant a motion to dismiss.

*Abu Dhabi Comm. Bank v. Morgan Stanley & Co.*<sup>65</sup>

Abu Dhabi Commercial Bank together with other plaintiffs brought a lawsuit against defendants including S&P and Moody's for "common law fraud, negligent misrepresentation, negligence, breach of fiduciary duty, breach of contract, unjust enrichment, tortious interference with contract, and aiding and abetting."<sup>66</sup> The plaintiffs, contending that the CRAs produced false and misleading "top ratings" of Cheyne SIV Rated Notes issued to a select group of investors, sought compensation from the liquidation of notes. Morgan Stanley acted as the placement agent and engaged the CRAs to rate the debt offerings. In exchange for "top ratings" of the structured Cheyne SIV's portfolio, the CRAs received three times the normal fees for devising ratings. The Cheyne SIV went bankrupt in the crisis of subprime mortgages. The court denied the CRA's motion to dismiss the fraud claims. Unlike *County of Orange* and *Jefferson Cty. Sch. Dist.*, this case marks a significant turning point as the court rejected the CRA's free speech argument.<sup>67</sup>

#### *Common Themes and Recent Cases*

A common theme in these cases is the CRAs' use of the First Amendment as its primary defence against liability for CRAs' ratings. For instance, CRAs stress

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<sup>61</sup>*County of Orange*, 245 B.R. 151.

<sup>62</sup>988 F. Supp. 1341 (D.C. Colo. 1999).

<sup>63</sup>*Ibid* at 1341.

<sup>64</sup>245 B.R. 151 (C.D. Cal. 1999).

<sup>65</sup>651 F. Supp. 2d. 155 (S.D.N.Y. 2009).

<sup>66</sup>*Ibid* at 176.

<sup>67</sup>Ribe (2010).

that their ratings are “pure opinion” or “public opinion;”<sup>68</sup> while plaintiffs argue CRAs should be subject to liability for issuers’ misstatements or “hostile ratings.”<sup>69</sup> Most recently, plaintiffs have brought “a broad array” of lawsuits against rating agencies in connection with structured investment vehicles based upon a few common law liability theories: breach of contract, negligence, fraud, and fiduciary duty.<sup>70</sup> One article provides a particularly apt summary of securities class action lawsuits as of November 15, 2008: there were approximately eighty 10b-5 related lawsuits and there were approximately twenty-four lawsuits concerning either Section 11 or 12(a) (2) liability.<sup>71</sup> Many of these lawsuits were filed in 2007 and 2008 after the “global credit crisis.” In the trial of these lawsuits, courts have broken through previous barriers (such as the CRAs’ use of the defences of press privilege and pure opinion) in imposing liability for ratings.<sup>72</sup>

In 2013, Department of Justice (DOJ) sued Standard & Poor's for fraud. S&P reached a settlement with DOJ to pay USD1.375 billion.<sup>73</sup> In January 2017, DOJ settled with Moody's and Moody's agreed to pay USD864 million for pre-crisis MBS ratings.<sup>74</sup> Based upon these cases, rating agencies should greatly raise their negligence standard of care, considering the factors of public interest, their role of “gatekeeper” and the increased global accountability on the part of rating agencies.

## Major CRAs in China

### *China Chengxin Credit Rating Group*

Founded in October 1992 as the first national credit rating agency approved by the PBoC, China Chengxin has become a leading credit rating provider. In 2006, China Chengxin established a joint venture with Moody's. Moody's brings internationally advanced rating technologies and methodological systems into CCXI. As a leading rating service provider in enterprise bonds, short-term financial bonds, structured financial products and debt financing instruments, China Chengxin Group, which is composed of China Chengxin (Asia Pacific) Credit Ratings Company Limited, China Chengxin International Credit Rating Company Limited, China Chengxin Securities Rating Company Limited, China Chengxin Credit Information Company Limited, and China Chengxin Credit Management Company Limited, is China's largest CRA.<sup>75</sup>

China Chengxin has obtained various rating qualifications granted by the regulatory authorities, such as PBoC, CBIRC, NDRC, State Economic and Trade Commission, Beijing Financial Assets Exchange, and Beijing Zhongguancun

<sup>68</sup>Freeman (2009).

<sup>69</sup>Examples include *Compuware Corp. v. Moody's Investors Servs. Inc.*, and *New Jersey Carpenters Vacation Fund v. HarborView Mortgage Loan Trust*.

<sup>70</sup>McGuinness (2009).

<sup>71</sup>Ferrell, Bethel & Hu (2008).

<sup>72</sup>Freeman (2009).

<sup>73</sup>DOJ (2015).

<sup>74</sup>DOJ (2017).

<sup>75</sup>CCXAP, [www.ccxap.com/About.aspx](http://www.ccxap.com/About.aspx).

Management Committee.<sup>76</sup> In October 2010, it received Type 10 license in Hong Kong. Over the past two decades, China Chengxin has achieved many first places in China's credit rating industry in corporate rating domestic corporate bonds, financial institutions, local government bonds, and structured products.<sup>77</sup>

#### *Dagong Global Credit Rating Co., Ltd.*

Dagong Global Credit Rating Co., Ltd. (Dagong Global) was founded in 1994 with the approval of the People's Bank of China and the previous State Economic and Trade Commission. As a nationally recognised credit rating company, Dagong Global has 600 staffs working in 34 domestic branches and two overseas branches.<sup>78</sup> In 2018, Dagong's market share in China accounted for about 20%.<sup>79</sup> In order to improve the internationalization of China's credit system and the construction of credit and information service market, Dagong Global signed a cooperative framework agreement with the Xinhua Net.<sup>80</sup>

Dagong Global pursues to reveal the connection between credit rating and social and economic development, reform the international credit rating system and develop the responsibility of credit rating.<sup>81</sup> After the global financial crisis, Dagong Global built its sovereign rating standard as the first sovereign ratings in China.<sup>82</sup> In the summer of 2010, Dagong Global issued China's first sovereign ratings report, which lowered the ratings of advanced countries (e.g. U.S., U.K. and France) and raised ratings of emerging markets.<sup>83</sup>

In September 2010, Dagong Global applied to the Securities and Exchange Commission (SEC) for registration as a NRSRO. However, the SEC denied its application for the reason that Dagong Global was not possible to "comply with the recordkeeping, production, and examination requirements of the federal securities laws".<sup>84</sup>

In order to realise its internationalization strategies, Dagong Europe Credit Rating Srl (Dagong Europe) was founded in Italy and registered as an European CRA in June 2013.<sup>85</sup> In July 2014, Dagong Global Credit Rating (Hong Kong) Co., Ltd. (Dagong HK) obtained the Type 10 license granted by the Securities and Futures Commission of Hong Kong (SFC). Dagong HK provides credit rating services for both entities and issuances, one-time and on-going, solicited and unsolicited, as well as both private and public ratings.<sup>86</sup>

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<sup>76</sup>This information is according to an interview with China Chengxin in November 2015.

<sup>77</sup>CCXAP, <http://www.ccxap.com/About.aspx>.

<sup>78</sup>Dagong Global, <http://en.dagongcredit.com/index.html>.

<sup>79</sup>Richter (2018).

<sup>80</sup>Xinhua Net (2009).

<sup>81</sup>Dagong Global, <http://en.dagongcredit.com/>.

<sup>82</sup>Ibid.

<sup>83</sup>Li (2010).

<sup>84</sup>SEC (2010).

<sup>85</sup>See the ESMA list of registered and certified CRAs as of June 3, 2013.

<sup>86</sup>Dagong HK, [http://www.dagonghk.com/AboutUs.php?act=list&parent\\_id=19&menu\\_id=251](http://www.dagonghk.com/AboutUs.php?act=list&parent_id=19&menu_id=251).

*China Lianhe Credit Rating Co., Ltd.*

China Lianhe Credit Rating Co., Ltd. (China Lianhe) was founded on the basis of restructuring of Fujian Province Credit Rating Committee in January 2000 in Beijing. Its registered capital is RMB 136 million yuan. In August 2007, China Lianhe established a joint-venture CRA with Fitch. At present, United Credit Management Limited holds 51% shares of China Lianhe as the controlling shareholder; Fitch holds 49% shares of China Lianhe.<sup>87</sup> China Lianhe has obtained all credit rating qualifications in China's capital markets and credit markets granted by the NDRC, PBoC, CSRC, CBIRC and Ministry of Industry and Information Technology (MIIT). In 2015, China Lianhe undertook 1,101 rating projects, including 1,032 initial rating projects; It participated ratings of 624 bonds, whose issue volume was RMB 1.12 trillion yuan.<sup>88</sup>

*Shanghai Brilliance Credit Rating & Investors Services Co., Ltd.*

Shanghai Brilliance Credit Rating & Investors Services Co., Ltd. (Shanghai Brilliance Rating) was founded in July 1992. As the first Chinese CRA that obtained all qualification and licenses (including License of Enterprise Bond Rating and License of Inter-bank Market Ratings granted by PBoC, License of Enterprise Bond Rating granted by NDRC, License of Eligible CRA granted by CBIRC and License of Corporate Bond Rating granted by CSRC) from Chinese supervisory authorities, it has established a technical cooperation with Standard & Poor's Ratings Services (S&P). Its ratings cover commercial paper, medium-term notes, corporate bonds, enterprise bonds, small and medium enterprises (SMEs) collective notes, financial bonds, asset-backed securities, local government bonds.<sup>89</sup> In particular, Shanghai Brilliance Rating has obtained quite a few first places in China's credit rating industry. It issued the first investment value report for Tsingtao Brewery Company Limited in 1994, the first bond rating of a securities company for Guotai Junan Commercial Paper in 2005, the first three ratings of collective notes of SMEs in 2009, the first foreign RMB-denominated bond rating for the Bank of Tokyo-Mitsubishi UFJ (China), Ltd. in 2010, and the first local government bond rating for Guangdong Province in 2014.<sup>90</sup>

**The Multiple Regulatory System of China's Credit Rating Industry**

In corresponding to the segmented regulatory system of China's bond market, its credit rating industry is regulated by multiple authorities. The People's Bank of China is the regulator of interbank bond market bond rating, which concerns issuance of treasury bonds, government bonds, municipal bonds, central bank bills, short-term financial bonds, non-banking financial bonds and asset backed

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<sup>87</sup>China Lianhe, [www.lhratings.com](http://www.lhratings.com).

<sup>88</sup>Ibid.

<sup>89</sup>Shanghai Brilliance Rating, [www.shxsj.com](http://www.shxsj.com).

<sup>90</sup>Ibid.

securities (ABS). China Securities Regulatory Commission is the regulator of exchange market bond rating, which concerns corporate bonds, government bonds and convertible bonds. In addition, credit ratings relating to issuance of enterprise bonds and certain bonds invested by insurance capitals must be accredited by the National Development and Reform Commission (NDRC) and China Banking and Insurance Regulatory Commission (CBIRC) respectively. Prior to 2019, a CRA applying for the license to engage in securities rating services from the CSRC must have Chinese legal person qualification.<sup>91</sup>

### *Multiple Regulators*

Prior to the establishment of the exchange bond market, the PBoC was the single regulator of the ratings market. The segmented bond market and the split supervisory system of financial market lead to a multiple regulator system for the ratings market. Accordingly, the rating activities are regulated by the following authorities:

	<b>The Inter-bank Bond Market (The PBoC as the Major Regulator)</b>	<b>The Exchange Bond Market (CSRC as the Major Regulator)</b>
<b>PBoC</b>	Commercial paper (CP), ultra-short-term financial bonds with a term of 270 days issued by non-financial enterprises, medium-term notes (MTN), small and medium-sized enterprises collection notes (SMECN), and private placement notes (PPN) <sup>92</sup> and project revenue note (PRN) in the inter-bank bond market	
<b>CSRC</b>		The CSRC and its dispatched offices shall supervise and administrate the securities rating business activities, <sup>93</sup> including: Short-term bonds issued by securities companies, corporate bonds, non-publicly issued corporate bonds (including privately raised SME bonds) and securitization products in the exchange market.
<b>CBIRC</b>	Financial bonds issued by commercial	

<sup>91</sup>Article 7 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.

<sup>92</sup>“Private placement notes”, also called as “private placement bonds of small and medium enterprises”, refer to the corporate bonds non-publicly issued and transferred by micro, small and medium enterprises within the territory of China, with principal and interest repaid within an agreed time limit”. See Article 2 of the *Shanghai Stock Exchange on Issues Concerning the Issuance and Implementation of the Pilot Measures of the Shanghai Stock Exchange for the Issuance of Private Placement Bonds of Small and Medium Enterprises* enacted on May 22, 2012.

<sup>93</sup>Article 6 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.

	<b>The Inter-bank Bond Market (The PBoC as the Major Regulator)</b>	<b>The Exchange Bond Market (CSRC as the Major Regulator)</b>
	banks, financial companies, financial lease companies, Tier 2 capital bonds of commercial banks, securitization products in the inter-bank bond market (former CBRC); Subordinated debts of insurance companies (former CIRC)	
<b>MOF</b>	Local Government Debts	Local Government Debts
<b>Ministry of Commerce (MOC)</b>	Short-term bonds and medium-term notes issued by non-financial lease companies	
<b>NDRC</b>	Enterprise bonds, project revenue bonds, small and medium enterprises collection notes, and micro and small enterprises support bonds in the inter-bank bond market	Enterprise bonds, project revenue bonds, small and medium enterprises collection notes, and micro & small enterprises support bonds in the exchange market

### *Cross Supervision*

In corresponding to the multi-supervisory system of bond market, the credit rating business is subject to the supervision of multiple supervisory authorities, including PBoC, CSRC, CBIRC,<sup>94</sup> NDRC, MOF, MOC, as well as two self-regulatory organizations – NAFMII and SAC. Of these organizations, PBoC and NAFMII are the main supervisors of ratings in the inter-bank bond market; the CSRC and SAC are the main supervisors of ratings in the exchange market. The multi-regulatory system derives from the split regulatory system of the bond market. Since different regulators may pursue different supervisory criteria and enforcement policies, in practice, it may result in regulatory loopholes and regulatory arbitrage.

Under the multiple supervisory system of credit rating industry, some credit rating activities are subject to cross supervision: (i) Ratings of debt financing instruments issued by non-financial institutions such as commercial paper (CP), ultra-short-term financial bonds with a term of 270 days issued by non-financial enterprises, medium-term notes (MTN), small and medium sized enterprises collection notes (SMECN), and private placement notes (PPN) and project revenue notes (PRN) in the inter-bank bond market are subject to the supervision of the PBoC and NAFMII; (ii) Ratings of enterprise bonds, project revenue notes, small and medium sized enterprises collection notes, which are approved by the NDRC and traded in both the inter-bank bond market and the exchange market, are subject to the supervision of the NDRC, PBoC, CSRC, NAFMII and SAC; (iii) Ratings concerning financial bonds issued by commercial banks in the inter-bank bond market are subject to supervision by the PBoC, CBIRC and NAFMII; (iv)

<sup>94</sup>China Banking Regulatory Commission and China Insurance Regulatory Commission merged as China Banking and Insurance Commission (CBIRC).



Ratings of bonds issued by insurance company in the inter-bank bond market are subject to the supervision of the PBoC, CBIRC and NAFMII; (v) Ratings of financial bonds issued by financial companies and financial lease companies are subject to the supervision of CBIRC, PBoC and NAFMII; (vi) Ratings of short-term bonds and medium-term notes issued by non-financial lease companies are subject to supervision of the PBoC, MOC and NAFMII; (vii) Ratings of securitization products issued in the inter-bank bond market are subject to the supervision of the PBoC, CBIRC and NAFMII; (viii) Ratings of securitization products in the exchange market are subject to the supervision of the CSRC and stock exchange(s); (ix) Ratings concerning local government debts in the inter-bank bond market are subject to the supervision of the MOF, PBoC and NAFMII; (x) Ratings concerning local government debts in the exchange market are subject to the supervision of the MOF, CSRC and stock exchange(s); (xi) Ratings of corporate bonds and private placement bonds are subject to supervision of the CSRC and stock exchange(s).

#### *Two Self-regulatory Organizations (SROs): NAFMII and SAC*

The National Association of Financial Market Institutional Investors (NAFMII) was founded in September 2007 in Beijing with the approval of the State Council. As of April 2012, members of the NAFMII were composed of 141 banks, 131 non-bank financial institutions, 5 financial service intermediaries, 475 intermediaries including credit rating agencies, 1911 corporations, Ministry of Railways and National Council for Social Security Fund.<sup>95</sup> The NAFMII enacted the *Self-regulatory Guideline for Credit Rating Business of Non-financial Enterprise Debt Instruments*, which was implemented on January 8, 2013, in accordance with the *Administrative Measures for Debt Financing Instruments of Non-Financial Enterprises in the Inter-bank Bond Market*. This self-regulatory guideline encourages double ratings.<sup>96</sup> The NAFMII recognises six CRAs' ratings in the inter-bank bond market, including China Chenxin, Lianhe, Dagong Global, Shanghai Brilliance, China Bond Rating, and Golden Credit Rating.<sup>97</sup> Recently, NAFMII is enhancing its self-disciplinary rules over CRAs' conflict of interest, inflated credit scores and consulting fees. CRAs. In March 2018, NAFMII issued guidelines for registration and assessment of credit rating agencies, which concerned both the interbank bond market and non-financial enterprises' debt instruments. In May 2019, NAFMII issued disclosure rules for credit rating business concerning interbank bond market and debt financing instruments of non-financial enterprises.<sup>98</sup>

The Securities Association of China (SAC) was founded in August 1991 in Beijing. Members of the SAC are composed of 109 securities companies, 84 securities investment consulting institutions, 6 CRAs, the China Great Wall Asset

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<sup>95</sup>NAFMII, [www.nafmii.org.cn](http://www.nafmii.org.cn).

<sup>96</sup>Article 6 of the NAFMII's *Self-regulatory Guideline*.

<sup>97</sup>NAFMII, [www.nafmii.org.cn](http://www.nafmii.org.cn).

<sup>98</sup>NAFMII, "Self-Disciplinary Rules", <http://www.nafmii.org.cn/zlgz/>.

Management Corporation (CGWAMC), and other ordinary and special members.<sup>99</sup> The SAC recognises six ratings of CRAs in the exchange market, including China Chenxin, Lianhe, Dagong Global, Shanghai Brilliance, Golden Credit Rating, and Penyuanyuan.<sup>100</sup> Under the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market*, the Securities Association of China (SAC) carries out the self-disciplinary management of securities-related ratings.<sup>101</sup> In September 2009, five accredited CRAs (China Chengxin, Dagong Global, China Lianhe, Shanghai Brilliance and Pengyuan Rating) signed the *Self-Disciplinary Convention of Credit Rating Industry*.<sup>102</sup> In January 2015, the SAC issued the *Detailed Rules for Implementation on Rating Business of Credit Rating Agencies in the Securities Market (Trial)*. This implementation rules stipulate criteria of business conduct for CRAs' due diligence, rating report, information disclosure and internal control.

## Other Legal Issues Concerning Chinese CRAs

### *Market Access*

In the *Catalogue for the Guidance of Foreign Investment Industries* (2015 Amendment), credit investigation and rating services are still listed as one of "restricted foreign investment industries".<sup>103</sup> Prior to April 2019, a foreign CRA must establish a joint venture with a Chinese CRA in order to get access to Chinese ratings market, upon the approval of the Ministry of Commercial. The shareholding ratio of a foreign CRA in the joint venture is capped at 49%. In September 1998, China Chengxin and Fitch Ratings established China's first joint-venture CRA—China Chengxin International Credit Rating Co. In 1999, Dagong Global and Moody's announced their technological cooperation. In 2006, Moody's acquired 49% shares of China Chengxin International Credit Rating Co., Ltd. In May 2008, Fitch Ratings acquired 49% shares of China Lianhe. In August 2008, Standard & Poor's signed strategic cooperative agreement with Shanghai Brilliance Credit Rating & Investors Services Co., Ltd.<sup>104</sup> Big Three CRAs have greatly promoted rating business of their business partners. In 2010, three major CRAs—China Chengxin, Lianhe Credit, and Dagong Global—accounted for 95% of domestic market share.<sup>105</sup>

The access to credit rating services in bond markets has been strictly managed by relevant regulators since mid-2000s. Of the Chinese CRAs that engage in

<sup>99</sup>SAC, "Credit Rating Institutions", [www.sac.net.cn](http://www.sac.net.cn).

<sup>100</sup>SAC, "Credit Rating Institutions", [http://www.sac.net.cn/en/SAC\\_Members/4/](http://www.sac.net.cn/en/SAC_Members/4/).

<sup>101</sup>Article 6 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.

<sup>102</sup>Hou (2009).

<sup>103</sup>See Item 29 of "Restricted Foreign Investment Industries" promulgated by the NDRC and Ministry of Commerce on March 10, 2015. Credit rating services have been categorised as "restricted foreign investment industry" since 2007.

<sup>104</sup>Shanghai Brilliance Rating (2012).

<sup>105</sup>Wang & Wheatley (2010)

nationwide credit rating business, four major CRAs (China Chengxin, Dagong Global, China Lianhe and Shanghai Brilliance) have full licensing accredited by four government authorities (PBoC, CSRC, NDRC and CBIRC) to provide rating services in both inter-bank bond market and exchange bond market.

	NDRC <sup>106</sup>	PBoC <sup>107</sup>	CSRC <sup>108</sup>	CBIRC <sup>109</sup>
Chengxin	✓	✓	✓	✓
Lianhe	✓	✓	✓	✓
Dagong	✓	✓	✓	✓
SH Brilliance	✓	✓	✓	✓
Pengyuan			✓	
China Bond Rating		✓		✓
Golden Credit		✓		
Fareast Credit	✓			✓

To reform the issuer pays model, China Bond Rating Co., Ltd. was founded by the NAFMII on behalf of all its members in August 2010. Its registered capital is RMB 50 million. This is the first CRA that adopts “investor pays model” in China.<sup>110</sup> It is also a re-rating agency. The business goal is to accumulate rating data of various industries in the inter-bank bond market and it is supposed to quit in five to ten years.<sup>111</sup>

#### *Avoidance from Conflicts of Interest*

Since China’s credit rating industry has a short history, the reputational mechanism does not work well and the competition for high rating grades has been serious.<sup>112</sup> In March 2006, Fuxi Investment Holding Limited issued the first phase of its short-term bonds -- “06 Fuxi CP01” whose issuing scale was CNY 1 billion and was due in March 2007. This is the first short-term financial bill issued by a non-listed privately operated (*Minying*) enterprise. “06 Fuxi CP01” was rated as “A-1” by Shanghai Far East Credit Rating Co., Ltd. (Shanghai Far East Rating) on December 28, 2005. However, Fuxi Investment involved in the scandal of Shanghai social security fund and some assets were frozen by the court in July. On July 26, 2006, Shanghai Far East Rating initiated the tracking rating system and announced the rating of “A-1” became temporarily invalid.<sup>113</sup> Thereafter, plenty

<sup>106</sup>Notification of NDRC Finance No. [2003] 1179 (11 September 2003).

<sup>107</sup>*Guiding Opinions on the Credit Ratings Management of the People’s Bank of China* (29 March 2006).

<sup>108</sup>*Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by CSRC (24 August 2007).

<sup>109</sup>*Announcement of the China Insurance Regulatory Commission on the Recordation of Recognised Capability of the Credit Rating Institution* (9 October 2013).

<sup>110</sup>China Bond Rating Co., Ltd., [www.chinaratings.com.cn](http://www.chinaratings.com.cn).

<sup>111</sup>Baidu Baike, “China Bond Credit Rating Co.”, <http://baike.baidu.com/view/4413444.htm>.

<sup>112</sup>Yuanfan Zhou (2012).

<sup>113</sup>Xu & Gao (2006).

of Fuxi's bonds were undersold.<sup>114</sup> On August 21, 2006, Shanghai Far East Rating downgraded the rating of "06 Fuxi CP01" to grade "C" for the reason of undisclosed loan guarantees for one of its shareholders, and thus became the first junk bond in Mainland China. The "Fuxi Event" called into question on the authority of domestic rating agencies. This event also negatively affected the reputation of Shanghai Far East Rating and its rating business declined thereafter.<sup>115</sup>

Take the example of the "AAA" rating of the Ministry of Railways. On August 8, 2011, the Ministry of Railways issued ninety-day super-short term financial bonds which valued at CNY 20 billion and the interest rate of bid winner was 5.55%. These bonds were rated as grade "AAA" by Dagong Global. This news gave a surprise to the public media since the Ministry of Railways had quite a lot negative news (e.g. the bullet train accident in Wenzhou on July 23, 2011) at that time. It turns out that the interest margin for each grade of "AAA", "AA" and "A" is about 30 basis points. In other words, the issuer may save CNY 150 million for raising one rating grade on the basis of issuing scale of CNY 20 billion.<sup>116</sup> The short-term bills issued by the Ministry of Railways are regards as "equivalent to national debts" because the Ministry of Railways bonds get implicit financial guarantee from the central government.<sup>117</sup>

However, the grade "AAA" was questioned by the public because it was even higher than the grade "AA" of China's national debts. In the first half of 2011, the debt ratio of the Ministry of Railways reached 58.33% (CNY 2.09 trillion in total with an annual interest of more than CNY 6 billion) but the accumulated net profit was only CNY 1.7 billion, according to its financial report.<sup>118</sup> Regarding the challenge of grade "AAA" of short-term railways bonds, the Dagong Global explained that the Ministry of Railways was both a state department and an enterprise legal person. If the Ministry of Railways was not able to pay the short-term bills, the state would pay back.<sup>119</sup> Further investigation shows that Dagong Global was the exclusive credit rating agency for the Ministry of Railways. The credibility of Dogong Global's "AAA" rating for railways bills indicates conflicts of interest between a CRA and its rated entity.<sup>120</sup>

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<sup>114</sup> According to the CSRC's requirement at that time, monetary market funds should invest in grade "A-1" or above short-term bonds; when there is a downgrade and the rating of short-term bonds is lower than "A-1", the short-term bonds must be sold in 20 trading days after the downgrade report is released. See Article 3 of the *Circular of China Securities Regulatory Commission on the Investment of Monetary Market Funds in Short-term Financing Bonds* issued by the CSRC on September 22, 2005 and became invalid.

<sup>115</sup> Gao (2006).

<sup>116</sup> CNFOL (2011).

<sup>117</sup> Ibid.

<sup>118</sup> Peng (2011).

<sup>119</sup> Qiao & Gao (2011).

<sup>120</sup> CNFOL (2011).

*Independence of CRAs*

In order to enlarge their market share, connections with local governments or financial institutions have been important for Chinese CRAs. An examination shows that Chinese CRAs may include local government or FIs in their shareholding structure. As a matter of fact, most Chinese CRAs had government background when they were incorporated in the 1990s. For example, large shareholders of Shanghai Brilliance Credit Rating Co. are China Foundation for Development of Financial Education (CEDF), Shanghai University of Finance and Economics, Shenergy Co., Ltd. and Shanghai Tiancheng Investment and Industrial Company.<sup>121</sup> Dagong Global was founded by eight entities including China Finance Society, China Academy of Social Sciences (CASS), China Aviation Science and Technology Committee, State Council Development Research Center, China Enterprise Association, China Enterprise Management Association and China Institute of Finance in June 1992.<sup>122</sup> Initially, China Lianhe was founded as Fujian Province Credit Rating Committee in 1995.<sup>123</sup> In 2009, Tianjin TEDA, a financial platform of Tianjin Government, acquired 50% shares of China Lianhe.<sup>124</sup> In 1988, Shanghai Far East Credit Rating Co. was founded by Shanghai Academy of Social Sciences, Shanghai Banking Information Consultation Center and Shanghai Academy of Social Sciences World Economy Institute.<sup>125</sup>

After Chinese CRAs' establishing joint ventures with the "Big Three" (Moody's, S&P's and Fitch) in mid-2000s, state capitals started to acquire shares of privately operated CRAs too. The first acquisition with state capital background was conducted by the Dongfang Asset Management Company Ltd. ("Dongfang AMC"). In August, 2007, Dongfang AMC signed the share transfer agreement with the Golden International Credit Rating Co., Ltd. and held 60% shares of the latter. The acquired CRA was renamed as "Dongfang Golden Credit Rating Co., Ltd."<sup>126</sup> In December 2008, Dongfang AMC purchased 51% shares of Shanghai Far East Credit Rating Co., Ltd. and the latter became a subsidiary of Dongfang AMC group.<sup>127</sup>

In 2009, state capitals engaged in the third acquisition of a privately operated CRA. Tianjin TEDA International Holding (Group) Co., Ltd. (TEDA Holding), which was founded by the Administration Committee of Tianjin Economic-Technological Development Area ("TEDA") as a local government platform to manage state-owned assets, purchased 50% shares of Lianhe Credit Rating Co., Ltd. (Lianhe Rating). Although Lianhe Rating did not need raise its capital and the joining of state capital did not add its credibility, Lianhe Rating was welcome to

<sup>121</sup>Baidupedia, "Shanghai Brilliance Credit Rating Co., Ltd.". <http://baike.baidu.com/view/8514014.htm>.

<sup>122</sup>Baidupedia, "Dagong Global Credit Rating Co., Ltd.". <http://baike.baidu.com/view/4008050.htm>.

<sup>123</sup>Dagong Credit Rating, "China's Credit Rating Agencies", <http://en.dagongcredit.com/>.

<sup>124</sup>Gao (2009).

<sup>125</sup>Dagong Credit Rating, "China's Credit Rating Agencies", <http://en.dagongcredit.com/>.

<sup>126</sup>Gao (2009).

<sup>127</sup>Ibid.

this acquisition because TEDA Holding controlled approximately 80% financial assets in Tianjin.<sup>128</sup>

After December 2008, Dongfang AMC had two CRAs in its affiliated group - Shanghai Far East Credit Rating Co., Ltd. and Dongfang Golden Credit Rating Co., Ltd. (Dongfang Golden). After a restructuring of shareholding structure, Dongfang AMC held 83% shares of Far East Rating. The two CRAs competed each other a couple of years, and finally Dongfang Golden obtained all rating licenses in both inter-bank bond market and securities bond market. Dongfang AMC decided to sell the Far East Rating. In November 2012, China Development Bank (CDB), China's biggest government-backed policy bank, took over the Far East Rating at the price of CNY 60.5 million.<sup>129</sup>

In another example, Pengyuan Credit Rating Co., Ltd. (Pengyuan Rating) is a Shenzhen-based CRA with the background of state capitals. Pengyuan Rating has two shareholders: the Shenzhen Financial Electric Settlement Centre and the Shenzhen Chengben Credit Service Co., Ltd. The first shareholder is a subordinate of the PBoC.<sup>130</sup> Since CRAs are supposed to play a third-party intermediary in the financial market, being controlled by state capitals or financial institutions may affect their status as an independent financial intermediary.

In accordance with the CSRC rules, CRAs are forbidden from carrying out securities rating business for a rated entity in certain circumstances, where concern actual or potential conflicts of interest with the actual controller, a shareholder of the CRA's 5%+ shares, CRA's management, analysts and their intermediate relatives.<sup>131</sup> When a CRA's controlling shareholder or actual controller is a financial institute, the CRA may not be able to play an independent role when involving in the above-mentioned conflicts of interest. In addition, state capitals should avoid involving in the rating services in order to keep the independence of CRAs and avoid from conflicts of interest.

### *Competition and "Rating Shopping"*

By 2011, there were more than 200 CRAs in China and the competition for limited market resources was critical. The issuer pays model played a dominant role in the ratings market. It turned out that rating charges were positively correlated to rating grades and the rating shopping was serious. Rating fees rise on a scale of high to low. In other words, the issuer paid more for higher ratings.<sup>132</sup> In practice, the bond issuer chose a CRA through bidding. That is, whoever provides higher rating and lower fees win the bidding.<sup>133</sup>

It is reported that the CRA only charged CNY 50,000 for a tranche of bonds up to CNY25.8 billion in Anhui. The reason for such a low charge is that institutional investors do not really recognise the rating reports from CRAs.

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<sup>128</sup>Ibid.

<sup>129</sup>Qiao (2013).

<sup>130</sup>Caijing (2008).

<sup>131</sup>Article 12 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.

<sup>132</sup>China Economic Net (2011).

<sup>133</sup>Qian (2011).

Since many CRAs have to use lower charges as a strategy to compete with their rivals, the profit of credit rating industry does not really rise accompanying the growth of bond markets. In particular, the market for credit ratings of SMEs bonds and local government bonds are quite competitive. In order to get business, local CRAs not only give inflated “AAA” rating to local government bonds but also charge small rating fees.<sup>134</sup> For example, Dongfang Golden Credit Rating Co. only charged CNY 80,000 for the credit rating of Shanxi Province government bonds.<sup>135</sup>

Another example is Dagong’s scandal in 2018. On August 17, 2018, NAFMII announced that Dagong was found to have “directly provided consulting services to rated companies” and overcharged high fees from November 2017 to March 2018. Additionally, the investigation by the China Securities Regulatory Commission (CSRC) indicated that Dagong has serious governance problems in “charging consulting fees from those being rated”, “hiring executives without professional qualifications” and losing “original documents for some rating services”. Thus, both NAFMII and CSRC decided to suspend Dagong’s domestic rating services for a year.<sup>136</sup> In April 2019, Dagong Global was taken over by the China Reform Holding Corp. Ltd., a state-controlled asset manager. This acquisition turns Dagong Global into a state-owned firm.<sup>137</sup>

On the other hand, institutional investors may not take credit ratings seriously due to the rigid redemption in China’s bond market. By June 30, 2018, 97% of 1,744 Chinese bond issuers were rated with AA and above, of which 464 bond issuers obtained the highest rating.<sup>138</sup> The rigid redemption resulted in the mismatch of credit ratings and risk premium.

#### *Inflated Ratings and Accountability of Credit Rating Agencies*

As of April 30, 2015, 22.5% Chinese onshore bonds were unrated.<sup>139</sup> Of the 77.5% rated onshore bonds, 34.8% onshore bonds were rated by international rating agencies, 35% onshore bonds were rated by domestic rating agencies, and 7.8% were rated by both international and domestic agencies.<sup>140</sup> Credit Rating Ranks in the inter-bank bond market is as follows:

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<sup>134</sup>Yuan (2015).

<sup>135</sup>Cao (2015).

<sup>136</sup>Wang (2018).

<sup>137</sup>Peng, Zhang & Shen (2019).

<sup>138</sup>Wang (2018).

<sup>139</sup>Manulife Asset Management (2015) at 7.

<sup>140</sup>Ibid.

Credit Rating Ranks for Medium and Long-term Bonds	Credit Rating Ranks for Short-term Bonds
AAA	A-1
AA	A-2
A	A-3
BBB	B
BB	C
B	D
CCC	
CC	
C	

However, it is common that the same rated entity got different ratings between domestic market and international market, between external ratings and internal ratings of commercial banks, or between inter-bank bond market and exchange bond market. Under the issuer pays model, inflated ratings are welcome to CRAs' clients. For example, some CRAs issue high grades of ratings. It is reported that Dagong Global issued 156 "AAA" grades for central enterprise bonds and corporate bonds of local governments' financial vehicles in 2010, including 15 credit ratings for enterprise, 3 enterprise bond ratings, 113 tracking ratings, 4 corporate bond ratings, 2 credit ratings for financial bond and 19 medium-sized notes. The 156 "AAA" grades accounted for 25% out of 624 ratings released on Dagong's website.<sup>141</sup>

Therefore, the accountability of some CRAs has been questioned. Regarding domestic credit ratings, internal credit rating departments of commercial banks usually issue lower rating grades than external rating agencies for the same rated entity or bonds. For example, small-sized local rating agencies appear to give higher ratings due to the intense competition for credit rating business.<sup>142</sup> Also, some cases show that CRAs may not follow rating procedure all the time. In March 2012, the Shanghai Chaori Solar Energy Science and Technology Company ("Chaori") issued three-year "Chaori-11 bond" (sz112061), which was rated by Pengyuan Credit Rating Co. Ltd. ("Pengyuan") as grade "AA" on July 13, 2011. However, Pengyuan failed to issue the tracking ratings within one month after Chaori announced its annual financial report. Pengyuan was warned by the Shenzhen Securities Regulatory Bureau for violating the rating procedure that Pengyuan submitted to the regulatory authority and late issuance of tracking rating for Chaori-11 bond. In 2014, Chaori-11 Bond (sz112061) became the first domestic corporate bond default.

In addition, it is noted that credit ratings assessed by domestic CRAs may be not equivalent to credit ratings assessed by international CRAs. Approximately, the domestic agency ratings of [AA, AA+ and AAA] are corresponding to international agency ratings of [BB, BB+, BBB-, BBB, BBB+, A-, A, A+ and AA-].<sup>143</sup> In other words, credit ratings assessed by China's domestic agencies are

<sup>141</sup>Hu, Li & Chen (2011).

<sup>142</sup>Song (2014).

<sup>143</sup>Manulife Asset Management (2015) at 7.



generally higher than credit rating assessed by international agencies. For example, in June 2015, three mainland CRAs – Dagong Global, China Lianhe and China Chengxin – gave an “AAA” rating for Evergrande Goup’s newly issued HK\$6.3 billion domestic bond, which was much higher the non-investment grade rating given by “the big three” and Standard & Poor’s just downgraded Evergrande Group’s rating from “BB-” to “B+”.<sup>144</sup> Another example is the disagreement between the mainland and international CRAs on the rating of Gazprom, the previous Russian Ministry of Gas Industry - Gazprom was given a “Baa3” by Moody’s; while Dagong Global gave an “AAA” for Gazprom.<sup>145</sup> According to a BIS working paper in 2017, ratings of Chinese bonds issued offshore, which were graded by international CRAs, were approximately six to seven notches lower than their ratings issued onshore and graded by Chinese domestic CRAs.<sup>146</sup> Other empirical study also indicated that rating criteria varied substantially among different Chinese CRAs.<sup>147</sup>

Accompanying the increasing debt defaults and accumulating financial risks in China’s financial system in recent years, the inflated ratings and credibility of some CRAs may be questioned. For example, of the corporate bond defaults totalling USD8.3 billion from January to September 2018, some companies were rated high scores (AA+ ratings) by domestic CRAs in 2017.<sup>148</sup> As a matter of fact, the WIND database shows that about 80% of onshore issued renminbi bonds were rated AA or above; ironically, six CRAs upgraded ratings as defaults increased in 2018.<sup>149</sup>

Aside from economic factors, policy risk matters in rating Chinese bonds. According to the Manulife Asset Management, questions such as “whether the rated entity is a SOE” and “whether the rated entity is a central SOE” are directly related to access to bank loans, state subsidies and government support. As to the private companies, their business must fit into the government’s policy orientation.<sup>150</sup>

#### *The First P2P-related Credit Rating Case: Duanrong Net v. Rong 360*

China is the largest country for online lending and it accounted for about 75% of the global market.<sup>151</sup> However, credit rating ranks for P2P lending is an underregulated area in China. Ratings and ranks on the same peer-to-peer lending platform graded by different rating agencies often vary. For example, *Xin He Hui* was rated as “C-” and ranked as “97th” by a CRA - Rong 360, but was ranked as “19th” by another CRA – *Wang Dai Zhi Jia*.<sup>152</sup> The investigation shows that there are no universal criteria for P2P ratings and the authenticity of data about peer-to-

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<sup>144</sup>Yam (2015).

<sup>145</sup>Ibid.

<sup>146</sup>Jiang & Packe (2017) at 2.

<sup>147</sup>Livingston, Poon & Zhou (2018) at 216–232.

<sup>148</sup>China Knowledge Newsletter (2018).

<sup>149</sup>Lockett & Jia (2019).

<sup>150</sup>Manulife Asset Management (2015) at 7.

<sup>151</sup>Wang & Dollar (2018).

<sup>152</sup>Lin (2016).

peer platforms are questionable; meanwhile, some CRAs have to “adjust” the result of ratings to cater for rated entities’ needs.<sup>153</sup> This case raises the issues of unsolicited ratings and unfair competition.

*Duanrong Net v. Rong 360* is the first lawsuit concerning peer-to-peer lending ratings. The plaintiff *Duanrong Net* sued the defendant *Rong 360* after its lending platform was rated as “C” and “C-” by *Rong 360*. The plaintiff claimed for a compensation of CNY 10 million. The cause of action is defamation infringement. The plaintiff challenged the legitimacy of *Rong 360*’s ratings because no CRAs got accredited from government authorities. The first court hearing was on December 15, 2015 at the Beijing Municipal Haidian District People’s Court. The plaintiff did not recognise the unsolicited ratings made by the defendant. The People’s University of China was added as a third party of the litigation since it was a cooperative partner of *Rong 360*’s rating business.<sup>154</sup>

On December 27, 2016, Haidian District People’s Court dismissed all plaintiff’s claims on the basis of absent legitimate qualification for P2P ratings. The decision of this case may be significant to clarifying unsolicited ratings and ratings for fintech firms.<sup>155</sup>

## Conclusion

The lessons from the role of CRAs in the subprime mortgage crisis raise critical issues such as conflicts of interest, accountability of ratings and liability of CRAs. As an emerging industry, China’s credit rating services have made progress in credit rating procedure, methodology and reporting, accompanying the rapid development of China’s bond market in the last decade. However, increasing debt defaults in recent years are challenging Chinese CRAs’ rating results. Unlike their counterparties such as the Big Three, self-regulatory system especially the reputational mechanism is weak in the Chinese context. Furthermore, China’s emerging credit rating sector operates under a multi-regulator system – the PBoC as the regulator of bond ratings on the nation’s interbank bond market and the CSRC as the regulator of bond ratings on exchange market. This multi-regulatory system may result in inconsistent policies and regulatory arbitrage. In the near future, it may be adjusted in the financial system reform and structure reform.

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<sup>153</sup>Ibid.

<sup>154</sup>Beijing Haidian District People’s Court (2018).

<sup>155</sup>Beijing Haidian District People’s Court (2019).

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