

ESMA Fines Five Banks for Negligently Issuing Credit Ratings

IN SHORT

The Situation: The European Securities and Markets Authority ("ESMA") has fined several banks for negligently issuing credit ratings on a professional basis without obtaining the necessary authorization to be a credit rating agency.

The Development: ESMA has stated that investment research and general investment recommendations may constitute a credit rating, despite the longstanding practice of so-called "shadow ratings" by certain actors in various Member States.

The Impact: Financial institutions are subject to a high standard of care and must ensure that investment research does not constitute a form of credit rating.

The ESMA published a statement on July 23, 2018, announcing that it had fined five Nordic banks €495,000 each for the unauthorized issuance of credit ratings. While these fines are still subject to appeal to the Board of Appeal of the European Supervisory Authorities and the Court of Justice of the European Union ("CJEU"), ESMA's approach demonstrates that financial market participants need to exercise great care when providing financial research in order to avoid both monetary fines and reputational damage.

The five banks in question, in line with established regional market practice, had included "shadow ratings" in the investment research that was made available to subscribers via email, the internet, and/or dedicated financial data providers. The research documents contained a specific letter or combination of letters in a manner similar to how credit ratings are usually assigned by established rating agencies. This research was produced as part of each bank's services in order to facilitate their clients' investment decisions and to offer some sort of scale to allow the reports to be meaningful and form the basis of meaningful comparisons.



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ESMA has concluded that the letters or combinations of letters qualify as a "rating category." Consequently, the research results constitute a credit rating that, in turn, triggers an authorization requirement under Regulation (EC) No. 1060/2009. ESMA is of the view (despite the explicit limitation to the scope of Regulation (EC) No. 1060/2009 in Article 3(2)) that information recommending or suggesting an investment strategy, investment research, and opinions about the value of a financial instrument or a financial obligation may still be considered a credit rating and that credit ratings and investment research constitute different, but mutually nonexclusive, concepts.

ESMA also found that the fined banks failed to meet the required standard of care when analyzing whether their investment research might qualify as a credit rating that would require authorization. Evidence for the required care would, normally, include any documentation showing that the bank has analyzed the possibility that a publication qualifies as a credit rating or that it has sought advice from competent authorities or independent counsel specializing in these matters. Lastly, the fact that "shadow ratings" might have constituted general market practice was not relevant, let alone conclusive, in ESMA's view.

THREE KEY TAKEAWAYS

1. Financial institutions need to be licensed as credit rating agencies if they provide statements about potential investment opportunities that qualify as credit ratings—regardless of what they call the ratings.
2. An entity that holds itself out as a professional entity and carries out regulated activities should be expected to exercise special care when assessing the risks that its acts and omissions might entail.



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3. Financial market participants should carefully assess whether a statement triggers a licensing requirement and be able to document the steps taken to analyze that a statement does not qualify as a credit rating.

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