Editorial

Dear reader,
In October 2012 the first issue of *The Dovenschmidt Quarterly* (DQ) was launched. This new scientific review attracted a vast number of reactions from readers and, on the basis of the call for manuscripts, potential contributors to *DQ*. These enthusiastic responses were triggered by the high quality and thought-provoking content of the various contributions, from economic analysis of China's economic growth (Guangdong Xu) via the mapping of public and private regulation (Cafaggi and Renda), the possibilities to boost sustainable governance (Elkington) to a critical reflection on systems of rating (Dommerholt).
The first issue of 2013 that now lies before you is, in our view, of the same excellent standard. This issue consists of an interesting article on regulating the operations of credit rating agencies in the European Union written by Amtenbrink and Heine. A very hot topic, given the important role of these commercial organizations and their huge influence especially in times of financial crisis, due to the overreliance on these institutions, the lack of due diligence-procedures and the lack of competition. Regulation of these players on the various levels is investigated in-depth and studied with regard to their effectiveness in terms of tackling market failures and the market perception of these agencies. Wessels has written a thought-provoking contribution on cross-border insolvency regulation and the possibilities and effects for and on corporate governance, with special focus on the recently published report on Global Principles for Cooperation in International Insolvency Cases.
Xinzhu Zhang and Vanessa Yanhua Zhang have studied the actual situation of anti-trust law and merger control in China after the enforcement of the Chinese anti-monopoly law three years ago. Whereas the global economy seems to be in recession, China seems to continue to show economic growth. Remarkably, however, this economic growth took place in an environment where competition policy was basically lacking. That has changed since 2007 when the anti-monopoly law was adopted. Many have wondered how the Chinese anti-trust authorities would exercise their particular duties. This is especially the case for merger control. China still has strong rules for foreign companies wishing to participate in the Chinese growth miracle: Foreign direct investment is often difficult or limited to joint ventures. Hence, many corporations seek the route of merging with Chinese companies. However, given the still large involvement of the state in China's economy, there was a fear that anti-trust authorities would abuse the possibilities given by the anti-monopoly law, *e.g.* to block mergers between Chinese and foreign companies for protective reasons. That is why a careful analysis of the way in which the Chinese anti-trust authorities exercise their powers is of great interest also for non-Chinese.
Last but not least, we bring a fascinating article on the threats to and challenges for enterprises in relation to the effects of climate change written by De Jong and Spier. These authors provide us with an interesting overview of the problems related to climate change and the potential liability risks they entail for companies and their senior officers. The basis for the legal obligation of companies to prevent the materialization of climate change risk as well as the potential defenses for companies when faced with liability claims are set out in this contribution. What is clear is that enterprises have every reason to place climate change on top of their agendas.
We trust that this new issue of *DQ* will intrigue and inspire all readers and will substantively contribute to the agenda concerning the global discussion on corporate life, law and governance.

The Editorial Board

Regulating Credit Rating Agencies in the European Union

Lessons from Behavioural Science

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1. Introduction

Since the beginning of the global financial and economic crisis, the search for its causes has been in full flight on both sides of the Atlantic. Exemplary for the direction that debates have taken in this regard is the 2009 De Larosière Report mandated by the European Commission, which identified a number of non-exclusive explanations, including, *inter alia*, fundamental failures in the evaluation of risk and the role that Credit Rating Agencies (CRAs) play in the assessment of credit risk.[1] On a global level the G-20 members have recognized the need to regulate CRAs.[2] This raises the question as to what the role of CRAs is in the financial markets, why this role may be problematic and how the main weaknesses of the present system can be addressed in the European Union (EU) and elsewhere.

The basic hypothesis at the outset of this contribution is that the current EU regulatory framework and what has been proposed by the European Commission in November 2011 does not fully succeed in effectively tackling failures in the CRA market and does not (sufficiently) take into account insights from behavioural economics into how market participants perceive credit ratings. Therefore, the main thrust of this paper is to point to insights from behavioural science, which might be important, when one is out to find new ways of regulating CRAs effectively. Strangely enough, behavioural issues have so far been largely neglected in the reform debates about CRAs. This contribution may not only add to the debate, but also give it a "behavioural turn".

The paper proceeds as follows: In Section 2 an outline of the economic core explanations for the existence of CRAs as well as of the key issues surrounding credit ratings are provided. In Section 3 insights from behavioural science into the workings of credit ratings will be included in the discussion. Section 4 proposes "competition" and "due diligence" of CRAs as a means to achieve better credit ratings. Against the background of the previous sections, in Section 5 the effectiveness of the current EU regulatory framework on CRAs and credit ratings is assessed.

2. The Economics of Credit Ratings: A Short Review

From the outset the question may be raised as to why commercial entities issuing credit ratings exist in the first place. For this it is necessary to understand the role that CRAs play in the marketplace. In doing so this section does not aim to provide an in-depth discussion of all theoretical aspects that might be involved in an economic analysis of CRAs, but rather to give an outline of the economic core explanations for the existence of CRAs as well as to point to some basic institutional features. In doing so, while being mainly descriptive in nature and referring to well-known ideas, some critical issues are raised that are yet unsolved.

2.1 The Market Structure of CRAs

The credit rating industry is highly concentrated. There are three major firms in the United States that dominate the market for credit ratings worldwide: Moody's; Standard & Poors (S&P); and Fitch. Moody's is an independent company exclusively issuing ratings. S&P's credit rating activities are only part of the larger financial information services that are provided. The company is owned by the publishing house McGraw-Hill. Fitch is owned by the French company FIMALAC. These three firms have branches all over the world. While Moody's and S&P provide extensive ratings coverage in Europe, Moody's has more coverage in Asia than does S&P, but S&P has more relative coverage in Latin America. In addition to the major U.S. rating firms and their branch offices, there are about

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1. De Larosière Report 2009, pp. 7 *et seq*. See also already International Monetary Fund (2008).
2. <www.g20.org/en/news-room/press-releases/235-communique-meeting-of-finance-ministers-and-central-bank-governors>.

35-40 additional credit rating firms in operation outside the United States.[3]

The market structure of CRAs has the characteristics of a natural oligopoly. The three leading CRAs (Moody's, S&P and Fitch) control about 94% of the world market.[4] The oligopolistic market structure becomes sustained and reinforced as a result of the large sunk costs of the reputational capital of CRAs.[5] Since reputation has to be built up over long periods, it is very difficult for newcomers to enter the market for credit ratings and to contest the market position of the incumbent CRAs. Beyond this "economic" barrier to entry, in 1975 a "legal" barrier to entry followed. The U.S. Securities and Exchange Commission (SEC) designated seven CRAs (including the big three) as Nationally Recognized Statistical Rating Organizations (NRSRO). Being labelled as an NRSRO is supposed to serve as a signal to the capital market that the CRA is of good quality in general. An NRSRO label qualifies a CRA also to testify for certain financial products; for example, SEC regulations require that money market funds contain only securities with a good NRSRO rating. To that extent it pays to be an NSRO. But whether the concept of NRSRO is also beneficial for the public is disputable. While in 1975 seven CRAs got the NRSRO status, in 2003 only the big three CRAs remained after a wave of merger in the years before. Currently, ten CRAs are accredited as NRSROs, after some efforts of the SEC to raise the number of NRSROs.[6]

It is obvious that the introduction of NRSRO and linking it to certain financial products has the effect of deterring competition on the market for credit ratings. As a result, economic and legal barriers to entry protect incumbent CRAs and stabilize an uncontested oligopoly with apparently low incentives to engage in price competition or competition for a better or different rating quality.

2.2 The Business Case for CRAs

Next to the actual market structure of the credit ratings business, the economic characteristics of the product CRAs are offering need to be understood. Here, in a nutshell the question arises as to why there is a demand for such a product in the first place.

Arguably one of the economic arguments in favour of credit ratings is that they reduce informational asymmetries between buyers and issuers of debt securities.[7] In line with that task is the definition of the International Organization of Securities Commission (IOSCO) that "a credit rating is an assessment of how likely an issuer is to make timely payments on a financial obligation".[8]

It can be contended that CRAs are appropriate bodies to provide financial assessment, as they not only have large experience in assessing issuers, but also realize economies of scale in the assessment of the creditworthiness of issuers with the help of large research facilities.[9] This means that a CRA can provide financial assessment at a much lower cost than a single investor who intends to buy a debt security. Consequently, a single financial investor who is confronted with the problem of informational asymmetry in most instances will opt to buy financial advice rather than to collect and to assess the necessary information by himself.[10]

Another feature of credit ratings is that they are informational goods, which have largely the characteristics of a public good: After the production of the information about the debt issuer has taken place, the information can be shared with others without incurring any additional production costs. In fact, in the face of today's available information technology, it is not feasible to exclude others from using the rating for free.[11] A straightforward consequence is that CRAs typically rely on an issuer-pays business model, whereby the services of CRAs are not paid by investors but by the issuers of debt securities. Investors get the rating information for free, thereby relying on the reputation of the CRAs not to sugarcoat the rating in the interest of the issuer.[12] Yet CRAs have to reconcile two at least potentially conflicting interests in this regard.[13] On the one hand, in order to safeguard the credibility of its ratings CRAs should have every interest not to soften their assessments of the creditworthiness. On the other hand, it has been observed that the business relationship that CRAs have with the issuer of debt securities, and particularly any ancillary services they may offer, means that they face the "incentive to overstate the creditworthiness of a particular product in order to build a good relationship with the issuer".[14]

Besides the (disputed) view that credit ratings can be useful, in order to overcome informational asymmetries between issuers and investors of securities, there is the argument that credit ratings can help to lower the costs of monitoring agents; for example, tying pension fund managers to the will of the dispersed fund owners. Investors can tie asset managers contractually to buy only those debt securities that have been rated to be of a certain quality (investment grading).[15] Of course, this mechanism is economically meaningful only if credit ratings truly measure and reveal all risks attached to debt securities. Yet this was not the case, for example, for the structured financial products, which triggered the financial crisis in 2008, where it has been observed that the same criteria for assessing quality were applied

3. White 2001.
4. European Commission 2008.
5. *E.g. The Economist* 2005; Herring 2009.
6. Including A.M. Best Company, Inc., DBRS Ltd., Egan-Jones Rating Company, Fitch, Inc., Japan Credit Rating Agency, Ltd., Kroll Bond Rating Agency, Inc., Moody's Investors Service, Inc., Morningstar Credit Ratings, LLC, and Standard & Poor's Ratings Services. As stated in U.S. Securities and Exchange Commission 2012, p. 8.
7. *E.g.* Katz, Salinas & Stephanou 2009; Cinquegrana 2009.
8. IOSCO 2003, p. 3.
9. Gonzalez *et al.* 2004; Cinquegrana 2009.
10. White 2010.
11. Mathis, McAndrews and Rochet 2009; Cinquegrana 2009.
12. Diamond 1989; Kuhner 2001.
13. Pagano & Volpin 2010.
14. De Haan & Amtenbrink 2011, p. 8.
15. Gonzalez *et al.* 2004.

as with corporate bonds.[16] In effect, fund managers were forced to buy structured financial products, because they got high ratings. But the applied rating technology was inappropriate and important additional information on liquidity and volatility risk of structured products was not released by the CRAs. Only when the financial crisis set in did it turn out that the ratings of structured products were calculated with very thin data samples and optimistic assumptions on default probabilities. Without that additional information it was not possible to make a correct risk assessment of structured products, neither for financial investors nor for their agents, such as portfolio managers.[17]

The informational deficiency of structured products in the event of the financial crisis points to a more general problem of credit ratings that is concerned with the transparency of the rating methodologies.

Transparency of rating methodologies and disclosure of critical assumptions of ratings may help to overcome informational asymmetries and principal agent problems. The idea is that with that extra information, investors would be able to assess more accurately whether the ratings are properly mirroring risk. Moreover, the transparency of the rating methodologies could also trigger more competition between CRAs.[18] However, the disclosure of rating methodologies has a severe drawback. Since in case of disclosure the competitors of the inventor can copy the research methodology, the incentive to innovate and to develop new rating methodologies might be severely mitigated. That is, a CRA will not itself take the initiative to invest in new research methods if the profits of that investment have to be immediately shared with competing CRAs.

What derives from these observations is that while credit ratings are, in general, a means to overcome informational asymmetries between issuers and purchasers of debt securities and, moreover, can be useful in tying the actions of portfolio managers (agents) to the will of investors (principals), the current market for credit ratings has severe market failures, which thwart self-organizing market processes between CRAs. The two most prevalent imperfections on the market for credit ratings are the economies of scale in the production of ratings in combination with sunk investments into the reputation of CRAs and the fact that credit ratings are informational goods.

3. Putting Life Into the Debate: Insights from Behavioural Science

From a methodological point of view, introducing insights from behavioural science into the debate on credit ratings implies that the rationality assumption of mainstream economic reasoning becomes relaxed. The relaxation of the rationality assumption will be carried out hereafter in three steps. In a first step the small literature on herd behaviour will be presented that is directly concerned with credit ratings. That survey will be followed, in a second step, by a short review of the psychological literature on giving and receiving advice. Although there is no consensus yet on how the availability of advice affects the actions of receivers of advice, it has been observed that the availability of advice has non-trivial effects on the actions of agents.[19] In a third and final step, the so-called lulling effect will be introduced.[20] That effect is concerned with the empirical finding that when persons are confronted with regulations, which have the purpose of protecting them, they often relax their own protective measures. This can result in the paradox outcome that persons were better off without regulatory protection. With regard to credit ratings and CRAs, the lulling effect points to the possibility that financial advice in combination with tough financial regulations may result in financial transactions that are less efficient than transactions that are not regulated and affected by financial advice.

The suggestion that less regulatory oversight and less reliance on credit ratings may lead to better decisions of financial investors is certainly provoking at a time when market intervention is on the return, and thus calls for substantiation. To this end, recent findings from neuroeconomics are introduced into the debate, which show that the proper processing and evaluation of financial information becomes hampered in the brains of decision-makers if they receive financial advice. They mentally “offload” the burden of properly evaluating a financial decision by believing overly in the recommendations of expert witnesses.[21]

3.1 Herd Behaviour and the Psychology of Advice

Until now there is no branch of economic literature that is specifically concerned with the behavioural economic aspects of credit ratings. However, there are some insights from behavioural science that have been connected to the analysis of economic effects of credit ratings. The most important finding is that credit ratings may trigger herd behaviour of investors and issuers of debt securities.[22] Moreover, there is an overreliance of decision-makers on the advice of others.

3.1.1 Herd Behaviour

The meaning of the term herd behaviour, in general, is that agents follow each other, like animals in a herd. Thereby, the term has a negative connotation; it implies that it would be wiser for agents to reflect their situation thoroughly and to deviate from the track of the herd. Herd behaviour is also sometimes termed as the lem-

16. Coval, Jurek & Stafford 2009.
17. Cinquegrana 2009.
18. *E.g.* Blaurock 2007; Cinquegrana 2009.
19. Bonaccio & Dalal 2006.
20. Peltzman 1975; Viscusi 1985.
21. Engelmann, Capra, Noussair & Berns 2009.
22. European Commission 2010.

mings-effect, which stresses the negative consequences of herd behaviour.[23]

The overall insight of the literature on herd behaviour is that agents, who act sequentially on the basis of private and public information about the behaviour of other agents, can be stuck to socially undesirable decisions. In the end all agents choose the socially non-optimal alternative.[24] Herding is an effect that is very common in financial markets. It has been theoretically analysed in the financial literature, and its evidence has been proved empirically in numerous studies.[25]

Credit ratings can influence the issuers of securities as well as the purchasers of securities. Starting with investors, the literature probes whether the public availability of credit ratings may help investors to overcome a lock-in into deficient decision-making due to false or incomplete private information. However, in an experimental laboratory study, Ferri and Morone show that credit ratings may not in every case prevent the herd behaviour of agents.[26] The effect of credit ratings is rather that they contribute to a quicker convergence of security prices to their fundamental value, which leads to welfare gains. Yet, arguably, a limitation of this study is that it is assumed that the rating agency has always superior and correct information about the security, while single investors have only limited and maybe false information. As the recent financial crisis has taught, this is a quite heroic assumption.

Issuers of debt securities may also tend to a sort of herd behaviour, when they try to place the majority of their securities as AAA deals. The rationale for their efforts to engineer financial products that appeal to the highest quality standards of CRAs does not primarily lie in their desire to be recognized as esteemed issuers of securities as such or in some kind of benevolence on their part. Instead this behaviour can be explained by the fact that investors often use heuristics to classify assets, which means that they routinely buy AAA assets because these assets were not problematic in the past.[27] Thereby, only AAA-rated securities are perceived to be riskless and thus of investment grade. In such an environment, issuers will try to ensure that most of their deals are rated as AAA, regardless of whether such deals in reality qualify for this highest rating. Put differently, investor demand triggers herd behaviour of issuers to carve out large portions of their deals as the highest investment grade rating.[28] That kind of demand-driven herd behaviour of issuers can be socially wasteful, as investors will often purchase AAA securities that are in fact of a lower quality. If thereafter it turns out that the rating of certain products has led to a false allocation of these products, reallocation decisions of investors support the advent of financial crisis.[29]

3.1.2 The Psychology of Advice

To better understand the behavioural aspects of credit rating information, it is also useful to observe the cognitive processing and evaluation of credit rating information. Credit ratings can be understood as a sort of financial advice, which is given by CRAs. The recipients of that advice are investors or their agents, such as portfolio managers.

There are various psychological findings that point to the fact that advice not only complements incomplete information of decision-makers, but may also have other non-trivial effects on decisions. As this contribution surely cannot cover all facets of the psychology of advice, it will focus on the (main) findings that are related to CRAs.[30]

In this context a first question is when do decision-makers utilize advice and when do they not? Surely, decision-makers will make use of advice to make better decisions, but they also seek advice to share responsibility.[31] Decision-makers feel more comfortable if they incorporate advice from others into their decision-making. However, that kind of emotional "offloading" incurs the risk that decision-makers may uncritically and falsely rely on advice. That is, investors of debt securities may rely overconfidently on credit ratings because they have a better emotional feeling, if they can share responsibility.

Another finding is that the accuracy of decision-making improves if decision-makers are taking advice. In fact, the quality of decision-making depends positively on the number of advisors, and past studies suggest three to six sources of advice seem to be enough to improve decision quality considerably.[32] In addition, the quality of decision-making improves, if the advice is independent and the content of advice differs.[33] However, decision-makers tend to abandon advisors whose recommendations are very different from those of the other advisors.[34] As a consequence, different perspectives on a given subject will not always be included into decision-making.

Applied to the context of CRAs, whereby credit ratings are considered to essentially constitute advice to investors, these insights may suggest that even the limited number of CRAs presently in the marketplace should be sufficient to ensure the quality of decision-making of financial investors. However, this conclusion rests on the assumption that advice offered by the leading CRAs is adequately independent and uncorrelated.[35] Moreover, the factual lack of differences in credit ratings from one CRA to the next triggers the utilization of credit ratings by investors. Therefore, it is quite possi-

23. Solow 1974; Akerlof 2001.
24. Banerjee 1992; Bikhchandani, Hirshleifer & Welch 1992; Ferri & Morone 2008.
25. Cont & Bouchau 2000; Bikhchandani & Sharma 2001.
26. Ferri & Morone 2008.
27. Barberis & Shleifer 2003.
28. Benmelech & Dlugosz 2010.
29. *Ibid*.
30. For a survey of the literature see Bonaccio & Dalal 2006.
31. Harvey & Fischer 1997; Yaniv 2004a, 2004b.
32. Budescu & Rantilla 2000; Yaniv & Kleinberger 2000.
33. Soll 1999; Johnson, Budescu & Wallsten 2001.
34. Harries, Yaniv & Harvey 2004; Sniezek & Buckley 1995.
35. Critical: White 2001.

ble that investors ground their decision-making especially on the advice of CRAs, if there is more than one credit rating available and if these ratings do not differ too much. Thereby, the recommendation of a credit rating (advisor) is preferred even more if it is (slightly) overconfident compared with other credit ratings (advisors).[36]

Finally, advice is seen as more helpful and will be less discounted if it is delivered by an expert source that has a long-standing reputation.[37] As a result, less "expert power" is contributed to new CRAs entering the rating market than incumbent CRAs, even if a new CRA is reliably signalling that it can assure a high quality of its ratings.[38] It may be argued that this attribution of "expert power" becomes fostered if a CRA receives a sort of official label, which presumably certifies its extraordinary quality, as has been the practice for some time in the United States , where a selected number of CRAs hold the licence as an NRSRO issued by the U.S. Securities and Exchange Commission.[39]

Overall, the literature on the psychology of advice points to some important characteristics of the circumstances under which investors are processing information of credit ratings. Recipients of advice intend to base their decisions on a more complete set of information (overcoming informational asymmetries). On the one hand, decision-makers seem to rely overconfidently on the advice of others, and, on the other hand, they emotionally "offload" responsibility for their decisions.

3.2 Lessons from the Lulling Effect

The findings of the psychology of advice are in accordance with the so-called lulling effect (or Peltzman effect), which points to the paradoxical empirical finding that regulations may not improve individuals' behaviour, but may lead to recklessness.[40] In other words, after regulation the situation of individuals may be worse than without or with less regulation.

The implicit logic of the lulling effect is that the protective effect of regulations is overestimated by those affected by the regulation. Individuals who find themselves protected by regulation will falsely reduce their own measures against harm by overrelying on the protection of the regulation. Put differently, in case of tight regulations, individuals may take higher risk levels than without regulation.

Empirically, this effect has been confirmed for regulatory activities in several domains, in particular in the field of safety regulations. After making car seat belts mandatory in the United States by means of the Motor Vehicle Safety Act of 1966, fatal car accidents were not immediately reduced, because drivers overcompensated the additional safety (by using the seat belt) by now driving more riskily.[41] A similar effect was observed when child-resistant screw caps became mandatory for the storage of drugs in the United States as a result of the Poison Prevention Packaging Act of 1970.[42] While the rule was actually aimed at the reduction of accidental self-poisoning of children, the self-poisoning of children increased after the rule had become effective. Investigations into this phenomenon revealed that the introduction of child-resistant screw caps had the adverse effect on parents of becoming more careless with the storage of drugs. Drugs were no longer kept with the same care as before the regulation, and hence children had a chance to "play" with the caps more often and to open them with sometimes fatal consequences.[43]

However, the miscalculation of the regulatory protection level may not only affect the individual caught by the scope of the regulation. Recklessness and higher risk taking may also harm third parties. For example, using a seat belt may protect motorists even if they are taking higher risks, but pedestrians and cyclists do not profit from the better protection of motorists.[44] They have to bear the full costs of the additional harm, and thus the negative externalities, that result from the careless behaviour of motorists.

What these and other examples of the lulling effect illustrate is that regulations can sometimes have an unintended impact on human behaviour. Individuals may be systematically self-deceptive in regard to the level of protection of a certain regulation.

The insights of the lulling effect can be transferred to the regulation of credit ratings. It is reasonable to assume that investors attribute too much credibility to those credit ratings, which are tightly (publicly) regulated. Investors may have caveats about the regulatory content of public regulations, but they are confident that the public regulation aims to overcome the problems of the credit rating business.

The application of the lulling effect to credit ratings is straightforward. It leads to the proposition that investors become more confident, the more credit ratings become publicly regulated. As a consequence, investors may reduce their own efforts to evaluate the default risk of debt securities at a higher rate than the one at which the effect of this overreliance is compensated by the increased rate of public regulation. The consequence is that investors purchase more debt securities, which have a higher rate of default. Investors would not have bought these debt securities if they had not strongly believed in the publicly monitored certification of debt securities.

What is more, similar to the example of car seat belts, the false risk perception of investors may affect not only themselves, but also third parties. For example, a bank may discover that its overconfidently purchased AAA debt securities have become almost worthless. This can

36. Price & Stone 2004.
37. Goldsmith & Fitch 1997.
38. French & Raven 1959.
39. See section 2.1. As to the situation in the EU see Section 5.
40. Peltzman 1975; Viscusi 1985.
41. Peltzman 1975; Peltzman 2007; Peterson & Hoffer 1994; Cohen & Einav 2003.
42. Viscusi 1985.
43. *Ibid*.
44. Peltzman 2007.

cause not only the bank's shareholders, but also the bank's customers to suffer; for example, a medium-sized company may get loans from the bank only at a higher interest rate or some business ventures may not get any credit. In addition, as liquidity dries up, the government may eventually have to take over the role of a lender of last resort to prevent the collapse of the bank. In that case also tax payers suffer from the lulling effect in the form of a negative externality.

The conclusion that can be drawn from the lulling effect is straightforward: While tight public regulation of CRAs may be aimed at improving the quality of CRAs and their ratings, one cannot exclude the possibility that higher failure rates of investor decisions may result. In such a perspective less regulation may yield better financial investment decisions, because purchasers of debt securities will more carefully evaluate whether a debt security has really earned the specific rating (for example AAA) by a CRA.

3.3 Financial Advice and the Human Brain – Evidence from Neuroeconomics

Theoretical evidence suggests that credit ratings lead to the overconfidence of investors, who engage insufficiently in evaluating and monitoring the risk of debt securities. The question is whether such findings can be backed by empirical observations highlighting what may be considered as reckless behaviour of financial investors. One approach to finding more empirical evidence is to observe the information processing of the human brain and to ask whether these processes lead systematically to judgment errors.

In a recent study Engelmann, Capra, Noussair and Berns examined how expert financial advice neurobiologically affects financial decision-making.[45] While undergoing functional Magnetic Resonance Imaging (fMRI) scanning, participants in an experiment had to make financial decisions. They could choose between a certain payment and a lottery. The choices had to be made under two framing conditions, whereby an expert financial advisor gave a recommendation or no advice was given. The results of this experiment showed a significant effect of expert advice on decision-making: It changed significantly the probability weighting functions of test persons in the direction of the expert's advice. This finding raises the important question whether it might be possible that receiving advice suppresses or entirely turns off an individual's valuation mechanism ("offloading" hypothesis).[46]

In order to approve the "offloading" hypothesis, neuroscans were conducted. The brains of test persons, some but not all of whom had received advice, and who had to make a financial decision (taking a fixed payment or choosing the lottery), were scanned. The neuro-scans showed that in the case where financial advice was provided, different regions of the brain were activated, compared with the cases where no financial advice was given. Obviously, financial advice is neurally not processed as a sort of "additional information", complementing information already vested in an individual, but it is treated as distinct information, which is processed in a different area of the brain. That is, the decision-making process undergoes a fundamental change when financial advice is given.[47]

The obvious question is, which areas of the brain become activated in case of (no) financial advice, and which function do these brain areas have? If no financial advice was available, brain areas of test persons were activated that are associated with decision-making under uncertainty[48] and in which elements of expected utility are processed.[49] When financial advice was released, these regions of the brain became deactivated. However, other regions of the brain became activated, which are associated with judgments of true and false beliefs that other individuals may hold. In these regions of the brain also the trustworthiness of trading partners in economic games is processed.[50] These regions of the brain became especially activated when only little information about the trading partner's character was available.

Finally, an important question is, which regions of the brain become activated if a person does not conform to the expert's advice. The experiment showed that the brain region associated with negative emotional states was activated. That means that it was emotionally uncomfortable for individuals to disregard the expert's recommendation.[51] An additional finding of the experiment was that the region of the brain associated with the encoding of negatively valued affections of risk became activated.

The findings from neuro-scans corroborate the insights gained from the study of herding behaviour, the psychology of advice and the lulling effect observed above. Overall it can be summarized that individuals tend to offload their responsibility to make decisions if advice is available, whereby individuals undertake only a little effort to verify whether the content of the given advice has sufficient quality. Instead of checking the quality of a particular recommendation, the brain is concerned mainly with considering whether the advisor can be trusted or not.

Both findings support the hypothesis that credit ratings may trigger the lulling effect. Investors overly trust the expertise of CRAs, especially incumbent CRAs, which have a long-standing reputation. Thereby, public regulation triggers even further overconfidence, because publicly regulated CRAs or publicly regulated credit ratings are seen as particularly reliable.

45. Engelmann, Capra, Noussair & Berns 2009.
46. *Ibid*.
47. *Ibid*.
48. Huettel 2006; Platt & Glimcher 1999.
49. Platt & Glimcher 1999; Sugrue, Corrado & Newsome 2004.
50. Delgado, Frank & Phelps 2005.
51. Engelmann, Capra, Noussair & Berns 2009.

4. Policy Conclusions: How to Avoid Overreliance

There are a lot of proposals concerning ways in which the quality of credit ratings could be improved, not all of which can be reviewed in this contribution.[52] What can be observed is that all proposals range between two extremes, as summarized by Brunnermeier, Crocket, Goodhart, Persaud and Shin:[53]

> "[T]here are two alternative generic approaches. The first is to remove CRAs and their ratings as far as possible from the structure of formal regulation altogether. Investment managers and bankers should take responsibility for their own decisions, and they (and their regulators) should no more be allowed to hide behind CRA forecasts than, for example, behind government forecasts of future growth. The alternative, second, approach is to register and to regulate the CRAs, but to leave them with a central role in the regulatory process."

Yet, what factors should determine this choice? Two mechanisms that regularly emerge in the reform debates and that also seem to be important to avoid the "lulling" of debt securities investors are "competition" and "due diligence". These two mechanisms are seen as instrumental in "nudging" investors and issuers of debt securities towards more efficient actions.[54]

4.1 Competition

The meaning of competition is that customers have a choice between different products and that suppliers are forced to sell their products at a price level that generates no monopolistic rents. In addition, competition stimulates innovations. Having a choice between different products implies that customers have to consider the quality of the different products and make up their minds about which product will be the best choice for them. Surely, making choices is not a simple task and sometimes wrong choices are made. Nevertheless, in general, competition between different products/sellers improves efficiency. The same must arguably also apply to credit ratings and CRAs. Also, it can be expected that the lulling effect will be decreased if investors have to make a choice between the products of various CRAs. They have to compare which financial advice is the most prudent one or they have to rely on their own capabilities to forecast the default risk of a debt security. In any case, fostering competition between CRAs makes financial advice more uncorrelated and it can be expected that the mental "offloading" of investors is decreased.

But to strengthen competition between CRAs is not a simple task. Given the market imperfections that are associated with the market for credit ratings, it cannot be expected that a workable competition between CRAs unfolds easily, if that market becomes simply deregulated. There is rather the need for competition enabling regulations, which are designed to prevent the exploitation of informational asymmetries and the occurrence of the lulling effect. Several conclusions can be drawn from this analysis.

First, the introduction of a central regulatory authority on the regional or global level for CRAs may be counterproductive. A uniform regulation of CRAs suppresses other different approaches to regulate CRAs. The existence of only one uniform regulation may trigger the perception of investors that this regulation is the best regulatory standard available. The lulling effect may be the consequence. Therefore, it might be preferable to allow for different regulations from different countries. In that case, investors have to consider not only the quality of a certain rating, but also the quality of the regulation behind that rating. The occurrence of the lulling effect will be decreased.

Second, linked to the first point, the licensing of CRAs by government agencies may not necessarily be the best way forward. Licensing suggests that a CRA has a certain quality on which an investor can rely. From the perspective of behavioural science, this is a strong trigger for the occurrence of the lulling effect. In addition, licensing forecloses market entry of new CRAs and subsequently competition. Only those new CRAs that fulfil the pre-defined standards can become competitors, but yet it would not be clear whether these standards are the best available or whether they only reflect a pseudo-high standard that aims at preventing the market entry of newcomers. What is more, licensing may be abused by governments to intervene in the rating business.

Thirdly, the business model of asset managers and CRAs needs to be reviewed. It should not be allowed to contractually bind asset managers to purchase debt securities of a certain rating level and/or of licensed rating agencies. While it is reasonable to oblige asset managers to act in a prudent way and to monitor their conduct, it is not useful to have a rating-based automated buying and selling of debt securities. First of all, relying blindly on the opinion of a CRA may lead to severe investment failures. Second, the offloading of responsibility for investment decisions by referring to a contractual obligation is a strong trigger for the lulling effect. Placing responsibility with the asset managers will make them more aware of the actual risk of a debt security. In addition, the abandonment of the requirement to buy only debt securities that have been rated by a licensed CRA can foster competition between CRAs.

For CRAs the business model that the issuer pays for the rating seems to be the only viable business model. This is not to say, however, that the business model cannot be improved, in order to provide more incentives for competition. Issuers pay for the services of a CRA when they have received the rating. Thereafter, the issuer can decide whether he will publish the credit rating or not. Consequently, shopping around is a frequent pattern of investors who are looking for the friendliest

52. A sample of reform alternatives is given by SIFMA 2008 and Mathis, McAndrews & Rochet 2009.
53. Brunnermeier, Crocket, Goodhart, Persaud & Shin 2009, p. 54.
54. Sunstein & Thaler 2008; Jolls & Sunstein 2006; Jolls 2011.

rating. This puts pressure on CRAs to provide top-level ratings. A possible means of reducing this potential conflict of interests on the part of CRAs is to have issuers pay the CRA for its services upfront and to oblige the latter to always publish the credit rating. In that case investors will learn about the reliability of issuers; for example, investors will be informed how often an issuer has tried to create and to place a debt security with considerable quality. Making transparent which debt securities have not been placed by issuers may make investors more aware of the quality of financial products and decrease the lulling effect.

Finally, the transparency (disclosure) of the applied rating methods and the underlying dataset of ratings should be enhanced. This will enable investors to evaluate more thoroughly whether a rating has been built upon appropriate methods and data. Also, this requirement makes it possible for third parties, like academics, to criticize a used method and the data sample. With respect to the lulling effect, the transparency of methods and data makes it more salient for investors that the quality of credit ratings depends in the first place on the underlying methods and data.

4.2 Due Diligence

The other important mechanism that prevents the lulling of investors is "due diligence". The concept stands for an obligation on the part of the CRAs to make deep investigations into the creditworthiness of issuers. While yet CRAs only review publicly available material of the issuer and private information,[55] which is freely given by the issuer, the obligation of due diligence would force the CRA to review also material that is not freely presented by the issuer. A CRA that cannot prove due diligence may be liable for the released credit rating. In the first place due diligence is a provision that forces CRAs to look for more substantiated information before a credit rating is released. The obligation to prove the quality of a debt security will decrease the problem of informational asymmetry between issuers and investors. However, it can also be expected that the lulling effect will decrease, because credit ratings will become more exact through due diligence. Also, in case a debt security defaults, there will be claims against the CRA, whether the CRA can prove due diligence. In these lawsuits information will be revealed that may be helpful for investors to overcome their sometimes deceived investment decisions.

5. The European Union Regulatory Approach to CRAs: Avoiding the Pitfalls?

Against the background of the insights from behavioural economics on how market participants perceive credit ratings, the question arises as to whether and to what extent the approach by the EU to regulating CRAs avoids the pitfalls sketched in the previous sections. Considering this focus, this part of the contribution does not aim at providing an all-embracing overview of the EU regulatory regime applicable to CRAs but rather zooms in on the main issues that have been identified above.[56] In doing so, first the background to the EU's regulatory activities is sketched. Thereafter, the currently applicable legal regime is discussed, followed by an outlook on the November 2011 legislative proposals by the European Commission to further enhance the rules on CRAs and credit ratings.

5.1 Background

Following the global financial and economic crisis that also resulted in turmoil in the European financial markets, as has been mentioned in the introduction, fundamental failures in the evaluation of risk and the role of CRAs in the assessment of credit risk have been identified as having contributed to the crisis. On the basis of a broad consultation process in late 2008, the European Commission presented an extensive proposal for a Regulation of CRAs,[57] which in somewhat amended form was agreed upon by the Council and the European Parliament in September 2009.[58] In opting for the introduction of a regulatory regime, the European Commission most notably decided not to follow the recommendations of the Financial Stability Forum, the Committee of European Securities Regulators and the European Securities Markets Expert Group, all of which, in acknowledging the role of CRAs in the financial crisis, had advised to reinforce the existing self-regulatory regime applicable to CRAs.[59] Yet the European Commission considered self-regulation would not suffice to ensure that "failures in risk assessment and risk management" referred to *inter alia* in the De Larosière Report would be a thing of the past.[60]

With Regulation 1060/2009, for the first time a European legal framework was introduced for CRAs. This is not to say, however, that previously CRAs had not been subject to any kind of regulation at all. Next to recognition of CRAs in the context of the Capital Requirements Directive for the purpose of credit assessments to determine capital requirements,[61] the former Committee of European Banking Supervisors (CEBS) had issued non-legally binding guidelines on the recognition of external

55. SIFMA 2008.

56. See generally Amtenbrink & De Haan 2009.

57. European Commission, 'Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies', COM (2008), 704 final.

58. Regulation 1060/2009 of 16 September 2009 on credit rating agencies [2009] OJ L 302/1.

59. See European Securities Markets Expert Group (2008); Financial Stability Board (2008); European Securities Regulators and the European Securities Markets Expert Group (2008).

60. De Larosière Report 2009, p. 10.

61. Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions [2006] OJ L 177/1. Namely Art. 81(1) and (2). See also Annex VI, Part 2 of Directive 2006/48/EC on the recognition of CRAs and mapping of their credit assessments Art. 80(1).

credit assessment institutions.[62] On the basis of the CEBS guidelines, initially the shared informal view by the competent national authorities was that credit institutions and investment firms could use the ratings of three leading CRAs, namely Fitch Ratings, Standard & Poor's Ratings Services, and Moody's Investors Service, to determine the risk weights of their exposures for capital purposes and on the mapping of their credit assessments.[63] However, neither the Capital Requirement Directive nor the CEBS guidelines regulated the licensing and supervision of CRAs in the EU.[64] The same held true for the non-binding standards by the International Organisation of Securities Commissions (IOSCO)[65] included in the "Code of Conduct Fundamentals for Credit Rating Agencies" (IOSCO code).[66] Nevertheless the IOSCO code was considered the benchmark for assessing the conduct of CRAs, and it is thus hardly surprising that at the time when the European Commission considering regulating CRAs in the EU in a more substantial way it leaned heavily on this standard.[67]

Following the introduction of the European System of Financial Supervision (ESFS), the three new European Supervisory Authorities (ESAs) Regulation 1060/2009 in 2011 became subject to substantial amendment to accommodate the new role of the European Securities and Markets Authority (ESMA).[68] Section 5.2 reflects on the Regulation as amended in 2011. What is more, in November 2011 the European Commission published a new proposal to amend the regulatory framework even further with a view to strengthening the existing legal regime.[69] This proposal is discussed separately in Section 5.3.

5.2 Towards Less Reliance on Credit Ratings, More Competition and Due Diligence of CRAs?

Overall, it can be argued that the currently applicable EU regulatory approach follows a double strategy that seems to be only partly attuned. On the one hand, from the moment of the introduction of the original 2009 proposal on CRAs, the European legislator has emphasized the undesirability of the overreliance on credit ratings by investors and the need to address this development in the financial markets. On the other hand, large parts of Regulation 1060/2009 in its currently applicable form are in substance geared towards improving upon the quality and reliability of credit ratings.

In order to be recognized as an External Credit Assessment Institution (ECAI) in accordance with the Capital Requirements Directive, CRAs established in the EU have to register with ESMA.[70] In addition, the European Commission has the right to certify CRAs situated outside the EU by means of an equivalence decision.[71] For this, the legal and supervisory framework of a third country must ensure that CRAs authorized or registered in that country comply with legally binding requirements that are equivalent to the EU legal requirements and that they are subject to effective supervision and enforcement in that third country.[72] At the time of writing this contribution, a total of 31 CRAs had been registered under the European scheme, including different country branches of the three biggest CRAs, Fitch, Moody's and Standard & Poor's.[73]

Next to this quasi-official seal of approval for CRAs operating in the EU, a rather comprehensive supervisory system has been set up geared towards ensuring compliance with the Regulation.[74] Supervisory tools range from the request for information, investigations and on-site inspections and may *inter alia* result in the temporary suspension of the use, for regulatory purposes, of credit ratings, the temporary prohibition to issue any credit ratings at all and the withdrawal of the registration of a CRA.[75]

Taking into account the insights from behavioural science discussed in the previous sections, the very introduction of a registration system of CRAs may be considered somewhat counterintuitive, as it may trigger a lulling effect, but in any event is unlikely to stimulate investors to make less use of credit ratings. Regulation 1060/2009 states that the use of the name of ESMA "in such a way that would indicate or suggest endorsement or approval by ESMA […] of the credit ratings or any credit rating activities of the credit rating agency" is not permitted, thereby excluding the use by CRAs of their official EU registration for commercial communication. Yet ESMA itself publishes a list of all registered CRAs on its webpage.[76]

62. Committee of European Banking Supervisors, "Guidelines on the Recognition of External Credit Assessment Institutions", 20 January 2006.
63. In April 2007 a similar statement was issued by eleven competent European supervisory authorities for the rating agency DBRS.
64. Amtenbrink & De Haan 2009.
65. IOSCO membership is primarily made up of national central banks and financial market regulatory and supervisory agencies.
66. *Code of Conduct Fundamentals for Credit Rating Agencies*, published by the technical committee of IOSCO, revised version of May 2008. Available www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf, accessed 24 September 2012.
67. European Commission 2008, p. 3.
68. See Regulation 13/2011 of 11 May 2011 amending Regulation 1060/2009 on credit rating agencies [2011] OJ L 145/30; Regulation 1095/2010 of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision 716/2009/EC and repealing Commission Decision 2009/77/EC [2010] OJ L 331/84.
69. European Commission, "Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies", COM (2011) 747 final. For an overview of the ESFS see Moloney 2010.
70. For the applicable procedure see Arts. 14-19 Regulation 1060/2009 (as amended).
71. *Ibid.*, Art. 5.
72. See *e.g.* Commission Decision of 28 September 2010 on the recognition of the legal and supervisory framework of Japan as equivalent to the requirements of Regulation 1060/2009 of the European Parliament and of the Council on credit rating agencies [2010] OJ L 254/46.
73. See <www.esma.europa.eu/page/List-registered-and-certified-CRAs>, accessed 24 September 2012.
74. Art. 21(1) Regulation 1060/2009 (as amended).
75. *Ibid.*, Art. 24.
76. See <www.esma.europa.eu/page/List-registered-and-certified-CRAs>, accessed 24 September 2012.

What is more, many of the substantive rules of conduct applicable to CRAs in the current EU framework are essentially geared towards increasing the quality of credit ratings or at least towards introducing a system of quality control at the European level. This includes, in the first place, the organizational and operational requirements geared towards ensuring the independence of CRAs and the avoidance of conflicts of interest.[77] This equally applies to the rules regarding the quality of rating analysts and other persons involved in the issuing of credit ratings.[78] Finally, also the disclosure requirements related to the methodologies, models and key rating assumptions a CRA has applied in its ratings activities,[79] as well as the introduction of rating categories for different finance instruments, may be interpreted to pursue the same aim.[80] All in all, it seems rather questionable whether any investor making the effort to acquaint itself with this regime would feel particularly discouraged to use credit ratings or not to rely on the ratings of any one CRA. If anything, the extensive regulatory regime suggests that the ratings of CRAs that adhere to the requirements under Regulation 1060/2009 can be trusted.

While Regulation 1060/2009 in its current form does not necessarily send out the signal to issuers and investors that they should rely much less on credit ratings, the quality requirements it introduces raise the standard of care that CRAs have to observe, and thus the due diligence of CRAs, at least to some extent. In the currently applicable EU regulatory framework there is, however, a notable absence of any specific civil liability regime for CRAs vis-à-vis investors.[81]

What is more, Regulation 1060/2009 does not include any particular measures to discourage including references in the regulatory framework to external ratings by CRAs. Put differently, the use of ratings for regulatory purposes has remained largely unaddressed. The undesired side effects of this have since been acknowledged by the European Commission, which points out in a 2010 working document that such references have the "potential to implicitly be regarded as a public endorsement of ratings and […] to influence behaviour in an undesirable way, for instance due to sudden hikes in capital requirements resulting from rating downgrades".[82]

Finally, the current EU regulatory framework can be criticized for its lack of measures to increase competition in this oligopolistic sector, despite the fact that the European Commission has recognized that there is a need to enhance competition among CRAs.[83] This point will be returned to in the next section.

5.3 The November 2011 European Commission Proposal: Filling in the Blanks?

The November 2011 European Commission proposal for the amendment of Regulation 1060/2009, which at the time of writing of this contribution is pending before the European Parliament in the 1st reading,[84] is *inter alia* aimed at mitigating "the risk of overreliance on credit ratings by financial market participants, the high degree of concentration in the rating market, civil liability of credit rating agencies vis-à-vis investors".[85] As such, the goal of the proposed amendment reads like a list of omissions of the existing EU regulatory framework on CRAs.

5.3.1 Overreliance Revisited

Whereas the current regulatory regime may be considered disappointing in not including major measures to reduce overreliance on ratings, the November 2011 Commission proposal includes a number of measures that are geared towards this aim. At the same time, by proposing to include rating outlooks also in the future, the scope of the regulatory framework is somewhat broadened.

At the outset it is useful to make a distinction between overreliance on ratings as such and overreliance on an individual CRA, whereby the latter has an impact on the level of competition between CRAs. With regard to the overreliance on ratings, the measures proposed by the European Commission address not only (individual) investors, but also financial institutions and even regulators and supervisors. Investors would become obliged to mandate at least two CRAs, each of which must provide an independent credit rating.[86] This obligation is, however, limited to structured finance instruments. Issuers of finance instruments should no longer be tied to any one CRA for more than three years, and an upper limit is introduced for the number of ratings a CRA is allowed to issue for the debt instruments of a particular issuer.[87] What is thus effectively proposed is a mandatory rotation of CRAs for the rating of finance instruments, whereby at the end of a contractual relationship in principle a "cooling off" period of four years applies.[88]

77. Art. 6 and Annex 1 Regulation 1060/2009.
78. *Ibid.*, Art. 7.
79. *Ibid.*, Art. 8.
80. *Ibid.*, Art. 10(3).
81. For a brief overview see Blaurock 2007, pp. 17 *et seq.*
82. Brackets added. European Commission, "Public Consultation on Credit Rating Agencies" (5 November 2010), p. 5. Available at <http://ec.europa.eu/internal_market/consultations/docs/2010/cra/cpaper_en.pdf>, accessed 24 September 2012. See Amtenbrink & De Haan 2011.
83. European Commission, Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EC) No 1060/2009 on credit rating agencies, SEC (2010) 678, p. 5.
84. At the time of writing of this contribution a draft report of the European Parliament Committee on Economic and Monetary Affairs was available in which amendments to the Commission proposals. Yet, as the fate of these amendments is unclear in the ongoing legislative process, they have presently not been included.
85. European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies, COM/2011/0747 final, Explanatory Memorandum, section 1.
86. *Ibid.*, section 11, proposed Art. 8b.
87. *Ibid.*, section 8, proposed Art. 6a.
88. *Ibid.*

Next to issuers and investors and, more generally, CRAs, also financial institutions are encouraged to rely less on credit ratings. Among others, it is foreseen that credit institutions, investment firms, insurance and reassurance undertakings, institutions for occupational retirement provisions, management and investment companies and alternative investment fund managers must make their own credit risk assessments. The European Commission proposal states in this regard that these parties "shall not solely rely or mechanically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument".[89] This measure is also supposed to reduce the so-called cliff effect in financial markets, that is, "sudden actions that are triggered by a rating downgrade under a specific threshold, whereby downgrading a single security has a disproportionate cascading effect".[90]

5.3.2 Limiting the Use of Credit Ratings for Regulatory Purposes

Apart from overreliance by investors and issuers on credit ratings and particular CRAs, the proposal also addresses the use of ratings for regulatory purposes. First, the three new European Supervisory Authorities (ESAs) are not supposed to credit ratings in their guidelines, recommendations and draft technical standards "where such preferences have the potential to trigger mechanical reliance on credit ratings by competent authorities or financial market participants".[91] Any existing guidelines and recommendations would have to be adapted accordingly should the proposed amendments become law. The same also applies to any recommendations and warnings issued by the newly established European Systemic Risk Board. Overall, the European Commission proposal includes some concrete measures to reduce the use of credit ratings for regulatory purposes.

5.3.3 Additional Disclosure Requirements

The European Commission proposal also foresees in further measures to increase the level of care that CRAs have to maintain in order to comply with the EU regulatory regime. First of all, several new provisions would be geared towards enhancing disclosure requirements. Among the most notable new requirements would be the disclosure of "any credit rating or rating outlook, as well as any decision to discontinue a credit rating, on a non-selective basis and in a timely manner".[92] The CRA must state its reasons for discontinuing a credit rating. Moreover, changes to the existing or the use of new rating methodologies, models or key rating assumptions have to be published by the CRA on the internet with an invitation to stakeholders to comment on the amendments.[93] Errors in the methodology or in its application must be notified not only to ESMA, but also to the public at large.[94] Moreover, additional reporting requirements for CRAs have been introduced for sovereign ratings. Sovereign ratings must be accompanied by a full research report and they must not be published before the close of business.[95] What is more, if the proposal should become law, CRAs would become obliged to (re-)assess sovereign ratings every six months instead of every twelve months.[96]

Interestingly, reporting requirements would not be limited to CRAs, as it is foreseen that issuers, originators and sponsors of structured finance instruments must disclose to the public, on a webpage run by ESMA,

> "information on the credit quality and performance of the individual underlying assets of the structured finance instrument, the structure of the securitization transaction, the cash flows and any collateral supporting a securitization exposure and well informed stress tests on the cash flows and collateral values supporting the underlying exposure".[97]

5.3.4 Reducing the Potential for Conflicts of Interests

The European Commission proposal once more sets out to address the potential conflicts of interests at CRAs. The aforementioned rotation system for CRAs engaged by an issuer is an important example in this regard. The same holds true for the proposed new rule that a leading analyst should not be involved in rating the same entity for more than four years regardless of on behalf of which CRA the analyst rates the entity.[98]

5.3.5 Enhancing Competition

In terms of enhancing competition, two more proposed measures are of interest. First, the European Commission proposal foresees the establishment of a European Rating Index (ERIX) to which CRAs have to submit rating information of all instruments rated by them. In order to make the rating outcome comparable across CRAs that may use different rating scales, the establishment of a standardized index is foreseen. However, CRAs remain free to use their own rating scales when they publish the ratings themselves.[99]

Finally, it is proposed that Regulation 1060/2009 include a civil liability regime. In the future in case a CRA intentionally or with gross negligence does not live up to its obligations, and to the extent that this infringement has had an impact on a credit rating, an investor that has relied upon such a rating can bring an action for any damage caused. In the proposal a CRA is considered to act with gross negligence "if it seriously neglects duties imposed upon it" by Regulation 1060/2009.[100]

89. *Ibid.*, section 6 proposed Art. 5a.
90. Commission Proposal 2011 n. 69, p. 4.
91. *Ibid.*, section 6, proposed Art. 5b.
92. *Ibid.*, section 11, proposed Art. 10(1).
93. *Ibid.*, section 10, proposed Art. 5a.
94. *Ibid.*, section 10, proposed Art. 8(7).
95. *Ibid.*, proposed new Part III of Annex I, section D.
96. *Ibid.*, section 10, proposed Art. 8(5).
97. *Ibid.*, section 11, proposed Art. 8a.
98. *Ibid.*, proposed point 8 in relation to Art. 7(4) of Annex I, Section C.
99. *Ibid.*, section 14, proposed Art. 11a.
100. *Ibid.*, section 20, proposed Art. 35a.

6. Conclusions

Following the global financial and economic crisis, and the role of CRAs therein, the legal regime applicable to credit ratings and CRAs have come under scrutiny both at the national and international levels. Overreliance on credit ratings, lack of due diligence and competition have been made out as major factors having contributed to the developments that put CRAs in a critical place in the crisis. Both in the United States and in the EU legislative activities could be observed aimed at increasing the regulatory oversight over CRA activities, where non-binding international standards and self-commitment were thought to have failed.

While this reaction to market failure and countermovement towards regulation may be expected, the question arises whether this approach is not in fact counterproductive to some extent. Insights from behavioural science suggest just that. As credit ratings can trigger a lulling effect, whereby public regulation triggers even further overconfidence, publicly regulated CRAs and the endorsement of the use of credit ratings by publicly regulation and bodies are perceived as particularly reliable. Competition and due diligence can be mechanisms, instrumental in pushing investors and issuers of debt securities towards more efficient actions.

Turning to the EU, the current regulatory framework applicable to CRAs falls short of effectively tackling market failures and, considering its substance, does not sufficiently take into account insights from behavioural economics into how market participants perceive credit ratings. European law seems to pursue a double strategy that is not necessarily well matched. On the one hand, the drafters of Regulation 1060/2009 intended to reduce overreliance on ratings. On the other hand, by introducing a registration and certification system of CRAs operating in the EU and whose ratings are used for regulatory purposes and, moreover, by introducing numerous measures geared towards increasing the quality and reliability of credit ratings, investors are not exactly discouraged from relying on ratings. Arguably, due diligence measures alone cannot achieve this aim. The currently applicable legal regime also does little to increase competition in the market for credit ratings.

The November 2011 Commission proposal for an amendment of Regulation 1060/2009 goes some way towards addressing some of these omissions. The obligation to use more than one CRA for the rating of a financial instrument as well as the obligation on parts of CRAs not to enter into contractual relationships with issuers for longer than three years may result in a diversification of the market for credit ratings. The introduction of EURIX may support this process. Next to this creation of more competition, the various measures to reduce the use of credit ratings for regulatory purposes and the requirement for certain financial market parties not to rely on external credit ratings can reduce the reliance on credit ratings somewhat.

To the extent that the European Commission proposal also further increases the due diligence of CRAs, it needs to be seen whether – if actually introduced – this actually results in more distinguished and exact ratings, thereby signalling to investors more clearly what the credit risks of a given financial instrument are and, moreover, what the risks of relying on a credit rating as a means of financial advice are. This is crucial as insights from behavioural science transferred to CRAs make it plausible that the EU regulatory approach will not dramatically alter the investor's conduct.

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A Global Approach to Cross-Border Insolvency Cases in a Globalizing World

Bob Wessels*

1. Introduction

On the date of publishing this contribution, Professor Ian F. Fletcher (University College London) and I will have issued our Report containing a set of Global Principles for Cooperation in International Insolvency Cases. These Global Principles reflect a non-binding statement, drafted in a manner to be used both in civil-law as well as common-law jurisdictions, and aim to cover all jurisdictions in the world.[1] In 2006, Fletcher and I were appointed by the American Law Institute (ALI) and the International Insolvency Institute (III) to prepare this Report. The ALI is a renowned legal academic institute, established in 1923 by judges, legal practitioners and academics, who collaborated as the "Committee on the Establishment of a Permanent Organization for the Improvement of the Law". ALI's general aim is "to promote the clarification and simplification of the law and to secure the better administration of justice". In Europe, ALI is known mainly for its role in the realization of so-called Restatements, comprehensive descriptions and explanations of certain major topics of law, such as the Restatements on the Law of Agency, Conflict of Laws, Contracts, Judgments, and Foreign Relations, for which ALI has a deservedly prominent place within the development of North-American law.[2] The III is, according to its tag line, a "Non-Profit Corporation Dedicated to the Improvement of International Insolvency Systems and Procedures". The III was established in 2000 as a "limited member organization". In 2012 the maximum number of members will be 300, including insolvency practitioners, scholars and judges.[3]

To a large extent the said Global Principles for Cooperation in International Insolvency Cases ("Global Principles") build further on the ALI's Principles of Cooperation among the member-states of the North American Free Trade Association (the "ALI NAFTA Principles"). These Principles have evolved from the ALI's Transnational Insolvency Project, conducted between 1995 and 2000, for which the Reporter was Professor Jay L. Westbrook, University of Texas, at Austin, Texas, USA. The objective of that Project was to provide a non-statutory basis for cooperation in international insolvency cases involving two or more of the NAFTA states of the United States, Canada and Mexico. The ALI NAFTA Principles were published as a separate volume in the four-volume text of the Transnational Insolvency Project (2003).[4] In 2002 III had decided to accept the ALI Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases and to promote its use.

In this contribution I will describe the structure and content of the Report, its relation to other initiatives in the world to create a better legal infrastructure for dealing with cross-border insolvency (reorganization or liquidation) cases, the scope of the Global Guidelines and the method used to arrive at where we are today. I will provide two illustrations of what Fletcher and I feel are important principles to further international insolvency law not only as a scholarly domain, but to assist judges and international insolvency practitioners in their approach to the conduct in these cross-border insolvency matters. Finally, I will conclude with emphasizing the Global Principles' aim and purpose.[5]

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1. The final Report, as presented to the American Law Institute in May 2012, is available via <www.bobwessels.nl>, weblog document 2012-06-doc1. I am grateful to Ian Fletcher for commenting on the draft version of this contribution.
2. For its website, see <www.ali.org>. On ALI's work, see Traynor 2007, pp. 145 *et seq*.
3. Most of its members actively participate in internal study groups and committees. III maintains a website, which contains one of the richest sources ("hard law", "soft law", "articles", and "protocols") of international insolvency law. For its website, see <www.iiiglobal.org>.
4. See American Law Institute, *Transnational Insolvency: Cooperation Among the NAFTA Countries: Principles of Cooperation Among the NAFTA Countries*, New York, Juris Publishing, Inc., 2003, hereinafter "ALI NAFTA Principles". As in the NAFTA Principles, the terms "bankruptcy" or "insolvency" are herein used as synonyms, although in worldwide English-language usage "insolvency" is the more common term for such proceedings where a business debtor is involved, whilst in the North American region "bankruptcy" is at least as often used for business proceedings as for those involving consumers. See NAFTA Principles Report 2003, at 1.
5. The final Report has been discussed and approved at the 89th Annual Meeting of ALI, 23 May 2012, Washington, D.C.. It has been unanimously approved by the membership of III at the 12th Annual Conference of III, 22 June 2012, Paris.

2. Structure and Contents

The Global Principles for Cooperation in International Insolvency Cases cover mainly three areas. After an introduction, Section II constitutes the heart of the statement, the Global Principles for Coordination of International Insolvency Cases. These Global Principles are the result of a global research survey that established the extent to which it is feasible to achieve a worldwide acceptance of the ALI NAFTA Principles, either in their existing form or, if necessary, with modifications or variations. Then follows Section III, which includes a review of the appreciation of the Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases ("Court-to-Court Guidelines"). These Guidelines in their original form were included in Appendix B of the ALI NAFTA Principles and represent procedural suggestions for increasing communications between courts and between insolvency administrators in cross-border insolvency cases. These Guidelines have been used in many cross-border cases, recently in such cases as *Nortel Network* and *Lehman Brothers*, in which some 70 insolvency proceedings in 17 countries all over the world are pending. The existing Guidelines have been revised in the light of subsequent developments in relation to this important form of cross-border cooperation that have been strongly influenced by the original Guidelines themselves. The text of the result of this review is recorded in Section III, with the heading Global Guidelines for Court-to-Court Communications in International Insolvency Cases.

An Appendix to the Report provides a glossary of terms and descriptions. As is explained in the Report, in recent times many states, regional public institutions, international non-governmental organizations, and practitioners' associations have produced many laws, regulations, principles, guidelines and statements of best practices, all aiming for the better coordination of insolvency measures or proceedings concerning economic enterprises that have operations, assets, activities, debtors or creditors in more than one state. The resulting complexity is compounded by a bewildering variety of technical terms and expressions used in the various texts. The Appendix aims to promote the development of a uniform global legal terminology in matters relating to insolvency and therefore to assist insolvency practitioners, courts and legislators in their efforts to improve the components to smoothen cross-border communication and coordination.

In a separate Annex we present a Statement of the Reporters, setting out our proposals for Global Rules on Conflict of Laws Matters in International Insolvency Cases. These proposals are not included in the Global Principles for Cooperation in International Insolvency Cases, but have been submitted to ALI and III as a useful starting point for further debate on a global level, bearing in mind the necessity to have these proposals tested against existing treaties or conventions and ALI's other work products and ongoing work on Principles related to other topics with conflict of law consequences. As Reporters, Fletcher and I feel that the Global Rules on Conflict of Laws Matters in International Insolvency Cases serve as legislative recommendations in general and sometimes in more detailed terms. They may also serve as a guide for courts, insolvency practitioners and creditors in those circumstances where applicable law with regard to international insolvency cases fails to deal with a certain point in issue or is vague. They do not purport to employ specific statutory language, however, as expressing conflict of laws rules in an appropriate way is a challenge for national or regional legislators. The main goal is to demonstrate that globally there is a wide measure of support for the enactments of rules of this nature, based on the given principle to avoid miscommunication, to prevent uncertainty, to provide accurate translation and to ensure smooth cross-border cooperation. A primary benefit brought about by achieving uniformity in the area of conflict of laws is that parties' legitimate expectations can be more consistently fulfilled, thereby reducing the levels of uncertainty and instability that have a key influence on the assessment of risk by those engaging in international transactions.

3. Background of the Global Principles

As indicated, the ALI NAFTA Principles were created some 10 years ago, with the focus on USA, Canada and Mexico. Having laid the groundwork for a wider dissemination of the ALI NAFTA Principles and their accompanying Guidelines, the ALI and the III considered in 2005 that it would be timely and appropriate to undertake a systematic evaluation of the possibility of adapting them so as to provide a standard statement of principles suitable for application on a global basis in international insolvency cases. The ALI NAFTA Principles, though written with the specific needs of the three NAFTA states primarily in mind, are necessarily of an international nature, and the Reporters for that project had expressed the hope that the Principles "may be helpful to our colleagues in other countries as well".[6] Nine years ago, Professor Lance Liebman, Director of ALI, as well as Professor Jay Westbrook (as the ALI Reporter) were of the opinion that these ALI Principles could be of use also beyond the NAFTA-countries. I quote:[7]

> "Although this Project seeks to take advantage of regional relationships to advance closer cross-border cooperation, it does not seek to exclude or limit coop-

6. See American Law Institute 2003, Reporter's Preface, p. xxi. See Westbrook 2005, p. 515. As a reminder, contrary to USA and Canada, Mexico belongs to the family of civil code countries.
7. See Westbrook (reporter), *International Statement of United States Bankruptcy Law* (2nd volume in: American Law Institute, Transnational Insolvency: Cooperation Among the NAFTA Countries, 4 Volumes), New York, JP Juris Publishing, Inc., 2003, pp. xvi and xxi. See at 7.

eration with countries outside of the NAFTA. On the contrary, many of the principles and procedures discussed below can be applied by courts in the NAFTA countries to cooperate with proceedings in non-NAFTA jurisdictions. The bench and bar are encouraged to draw on those principles to increase cooperation in those instances as well, even though we cannot expect as high a level of cooperation as we hope to achieve within the NAFTA."

The Global Principles Project was conceived and approved as a joint venture between ALI and III. In February 2006 ALI appointed Fletcher and me as Reporters for the project, initially titled "Transnational Insolvency: Principles of Cooperation", which during the course of research and discussions was changed to: "Transnational Insolvency: Global Principles for Cooperation in International Insolvency Cases". The most important objective within the remit of the project was to establish the extent to which it is feasible to adopt "at a global level" the ALI NAFTA Principles together with the Guidelines, including their alignment with certain comments received. The Reporters therefore developed a systematic consultation exercise, conducted with the help of experts drawn from a wide range of jurisdictions and legal traditions around the world and able to pronounce authoritatively on the feasibility of applying the Principles (or conversely, any obstacles to doing so) from the perspective of each state and legal system with which they have direct personal experience. In addition, we considered it to be both appropriate and necessary to take account of the considerable volume of work that has already been carried out in this field in recent years.[8]
In the text, the terms "cooperation", "coordination" and "communication" play a major role. Within the ALI NAFTA Principles, "cooperation" encompasses "a variety of approaches to make legal systems work together better in addressing multinational problems, without necessarily making the systems more similar". The term "coordination" is sometimes used to mean "….a limited harmonization aimed at making two different systems work better together, without being fully harmonized".[9] "Communication" relates to certain forms of exchange of information between different jurisdictions via various role players (courts, insolvency office holders, court clerks, certain other authorities) as a means to cooperate or to coordinate pending insolvency proceedings or developments within an international insolvency case.[10] In the approach taken in the ALI NAFTA Principles, the Global Principles project is directed primarily at cooperation, but in its recommendations seeks a measure of coordination as well.[11]

4. Relation to Current and Future Developments in Soft (International) Insolvency Law

A number of projects and studies that either directly or indirectly relate to national and cross-border insolvency matters have been conducted by such organizations as the Asian Development Bank, the World Bank, the IMF, the European Bank for Reconstruction and Development, the United Nations Committee on International Trade Law (UNCITRAL), and by other bodies of experts (for example, the Principles of European Insolvency Law 2003 and the European Communication and Cooperation Guidelines for Cross-border Insolvency 2007). As a result of the work of these organizations and bodies, there have emerged a number of texts, variously called "principles", "guidelines", "good practice standards" or "recommendations". These texts amount to a striking demonstration of the globalization of commercial activity in the insolvency era, and the raised awareness internationally of the need to address the issues associated with insolvency in a cross-border context.[12]

8. See Wessels 2009, pp. 587-611.
9. American Law Institute 2003, p. 3.
10. Where the Reporters aim to further build on the accepted concepts and terms of the ALI NAFTA Principles, the report does not follow the distinctions recently made by the Austrian author Geroldinger, to use the term "coordination" as the result of "collaboration", which term itself covers all topics of information exchange ("communication"), all other matters in which different proceedings pending in different states can influence each other ("intervention" possibilities), "cooperation" (actually aligning approaches to pending proceedings) and "harmonization" or "uniformation" (as found in certain provisions of the EU Insolvency Regulation, such as Arts. 7(2) (reservation of title), 20 (return and imputation), 29 (right to request the opening of secondary proceedings), 30 (advance payments of costs and expenses), 31 (duty to cooperate and to communicate), 32 (exercising creditors' rights), 33 (stay of the process of liquidation in secondary proceedings), 34 (measures ending secondary proceedings), 35 (assets remaining in the secondary proceedings), 39 (right to lodge claims) and 40 (duty to inform creditors). See Geroldinger 2010, pp. 25 *et seq*. See Wessels 2011a, pp. 27 *et seq*.
11. Cooperation in cross-border cases between courts is based on the premise that these courts, in principle, act on the same footing and are not subordinated to one another, see, in general, Nunner 2009, pp. 112 *et seq*.
12. In the same way Tomasic 2007, pp. 229-242.

5. Relation to Current and Future Developments in (International) Insolvency Legislation

Furthermore, account has been taken of the fact that some of the central issues addressed in the original ALI NAFTA Principles (including recognition, relief, and cooperation) have, since ALI's adoption of the text in 2000, found their way into national or federal legislation. In the USA, since 17 October 2005, Chapter 15 of the US Bankruptcy Code has been in place.[13] It enacts virtually all the provisions of the UNCITRAL Model Law on Cross-Border Insolvency of 1997 and thereby encapsulates several of the ALI's Principles. In Great Britain an amended version of the Model Law became effective as of 4 April 2006. Other states have also enacted legislation within which the Model Law, and hence some aspects of the ALI Principles, are reflected. These states include Australia, British Virgin Islands, Canada, Cayman Islands, Colombia, Greece, Japan, Ireland, Mauritius, Mexico, Montenegro, New Zealand, Poland, Romania, Serbia, Slovenia, South-Africa and South Korea.[14]

Since 2002 a significant contribution to the process of international insolvency has been made by the entry into force of the EU Insolvency Regulation. Several topics dealt with in ALI's Principles are now applicable on a compulsory basis in 26 of the 27 EU Member States. These topics include, *e.g.*, cooperation (between "liquidators") in parallel proceedings, recognition, access to court, information and communication, claims filing and avoidance actions, as well as rules governing – for intra-Union cases – jurisdiction to open insolvency proceedings and jurisdiction in respect of insolvency-related matters, the recognition of foreign proceedings, and uniform rules of conflict of laws. In 2004 the UNCITRAL published its Legislative Guide on Insolvency Law, which forms a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features. As a novelty, the Guide contains certain recommendations regarding applicable law in international insolvency cases. Like the ALI NAFTA Principles, the Legislative Guide contains considerations and suggestions with regard to group consolidation. In July 2009 UNCITRAL adopted the Practice Guide on Cross-Border Insolvency Cooperation ("UNCITRAL Practice Guide") containing information for insolvency office holders and judges on practical aspects of cooperation and communication in cross-border insolvency cases.[15] The Guide's recommendations regarding applicable law in international insolvency cases sparked our intention to suggest our personal proposals for such matters in our work, laid down in a separate Annex to the Report, which sets out Global Rules on Conflict of Law Matters in International Insolvency Cases. Here, another source should be mentioned that has facilitated the Reporters' work, namely the steadily growing body of in-depth studies devoted to many varied topics of international and comparative insolvency law in this decade.[16]

Hence, as an integral part of the Global Principles Project, we thought it would be a challenging but valuable and necessary task to identify such core values and principles as can be discovered from a comparative analysis of the available texts, evaluated in the context of the consultative debate among the participating experts. As a result, Fletcher and I believe that the Global Principles for Cooperation in International Insolvency Cases are therefore in line with other international developments and other attempts of developing modes of international cooperation in the area of international insolvency.[17]

6. What Was Excluded

As Reporters, we were conscious of the fact that our research, from which the Global Principles were produced, could have included other matters that it would have been appropriate to explore with a view to ascertaining the prospects for acceptance of global standards to be applied in the transnational insolvency process. A number of issues that have an important bearing upon the overall quality and efficiency of the international insolvency "process" were either not directly addressed in the context of the earlier project that yielded the ALI NAFTA Principles, or were dealt with on a somewhat tentative basis. These include the principles and procedures to be applied where insolvency occurs within multinational corporate groups (the subject of the original Procedural Principles 23 and 24 of the ALI NAFTA Principles). Further issues that we believe to be in need of study and development are the elaboration of internationally tenable standardized principles of professional behaviour of insolvency office holders. Although of direct relevance to the goal of promoting effective co-operation in international insolvency cases, it was decided that these and other issues should be studied and

13. Pursuant to Recommendations 1 and 6, see American Law Institute, Transnational Insolvency: Cooperation Among the NAFTA Countries: Principles of Cooperation Among the NAFTA Countries, 2003, pp. 93, 99.

14. These countries are listed by UNCITRAL as having enacted legislation based on the Model Law, see <www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html>. It should be noted, however, that also the Ley Concursal of Spain (2003), and draft legislation in the Netherlands (2007) have been inspired by the Model Law, see Wessels 2008, p. 19, and Aurelio Esplugues & Barona-Vilar 2011. Available at SSRN: <http://ssrn.com/abstract=1952782>.

15. See Clift 2009, pp. 405 *et seq*.

16. However, on the basis of the languages at the Reporters' command, only a selection written in German, French or Dutch could be analysed, along with those published in an English version.

17. For a recent overview of this area, see Wessels 2012.

dealt with by other international institutions or associations, which have taken these topics on their respective agendas.[18]

Regarding multinational corporate groups the Reporters welcome UNCITRAL's publication, in July 2010, of Part Three of the Legislative Guide ("Treatment of enterprise groups in insolvency"). In the light of this development, which started in the period the Reporters were appointed, it was decided that it was unnecessary to undertake a parallel exercise as part of the Global Principles Project. In line with Procedural Principles 23 and 24 of the ALI NAFTA Principles, we feel that it should be permissible to commence an insolvency proceeding for an insolvent subsidiary in the same jurisdiction as the parent's insolvency, and to have either procedural or substantive coordination or (partly) consolidation under applicable law, absent a proceeding involving the subsidiary in the state of its main interests. Where the subsidiary is in a parallel proceeding in the state of its main interests, coordination between the two proceedings should achieve the benefits of consolidation where possible. The principles of coordination and cooperation should include parallel proceedings involving a subsidiary of a foreign parent debtor to the same extent as with parallel proceedings involving the debtor, although certain decisions, such as allocation of value, may be differently determined because of the need to honour the corporate form. We consider this approach to be fully consistent with the overall spirit and substance of the surrounding Global Principles and therefore would encourage, wherever possible, the use of these Principles so as to facilitate or increase the prospects of cooperation in other proceedings taking place. We are, however, obliged to acknowledge that the responses of our consultants and interviewees have indicated that it cannot be claimed that this point of view commands widespread acceptance in national law and practice at the present time.

In formulating their proposals we have used texts or explanations to their meaning without taking into account the nature of a debtor or its particular status under national or regional law. However, we must acknowledge that certain categories or types of debtor will possess characteristics that mark them out for distinctive treatment in the event of insolvency. These include financial institutions and natural persons. With regard to financial institutions (credit institutions, insurance undertakings, (collective) investment undertakings, etc.), several international standard setting organizations or national and regional legislatures have developed or are in the process of developing rules or recommendations that – in a variety of ways – stress the paramount importance of the stability of the (international) financial markets, including the protection of financial interests of a large number of individuals concerned, and the prevention of systemic risks. These goals often result in specific regulatory regimes and in specific aims of the respective legislation or recommendations, including swift and targeted actions of authorities and specific international rules regarding cooperation, given the public nature of supervisory institutions involved. Although some of the Reporters' recommendations may serve the purposes mentioned or could assist in earlier phases of financial distress of such institutions or some of its entities, which are excluded from said specific rules, the present proposals make no claim to deal with these financial institutions.[19]

The same approach has been chosen with regard to natural persons (sometimes also "consumers", "non-merchants" or "non-traders"). Although in recent years several states have adopted special insolvency regimes for non-traders or natural persons, such rules are lacking in many countries, including – in Europe – Italy, Hungary and Latvia. Also in the area of natural persons some other purposes in legislation have a primary attention, such as the protection of a certain minimum of assets and income, available for an individual natural person (and his household) or the "financial rehabilitation of over-indebted individuals and families and their reintegration into society".[20] While some of these recommendations could provide guidance in certain matters, we have not primarily addressed such natural persons as insolvent debtors.[21] Overall, the Global Principles apply to those groups of (legal) persons which play their part in (international) commerce and business.

7. Method of the Project

The aim of the Project, as outlined above, is to have a global reappraisal of the ALI NAFTA Principles and its accompanying Court-to-Court Guidelines from the perspective of a wide and diverse array of national insolvency systems and legal traditions, in order to test the feasibility of their being endorsed as the embodiment of "global best practice" or "world standard" in the matters addressed therein. The approach chosen has been an open-minded spirit, aiming at transparent and open

18. An overall view, also describing UNCITRAL's developing work regarding "enterprise groups", is provided by Sarra 2008, p. 73. The European Bank for Reconstruction and Development (EBRD) has released the "EBDR Insolvency Office Holder Principles" (June 2007), intended to assure that member-countries employ qualified, regulated and impartial persons for positions that are key in insolvency proceedings, see <www.ebrd.com/country/sector/law/insolve/princip/princips.pdf>. See Walters 2009, pp. 49-56.

19. See Westbrook 2011, pp. 185 *et seq*. See my proposals in: Wessels 2011b, pp. 139-164.

20. See recommendation 4(f) of the Council of Ministers of the Council of Europe (20 June 2007) to its (over 40) member states "[to] introduce mechanisms necessary to facilitate rehabilitation of over-indebted individuals and families and their reintegration into society in particular by: …. f. encouraging effective financial and social inclusion of over-indebted individuals and families, in particular by promoting their access to the labour market", Recommendation CM/Rec(2007)8, <https://wcd.coe.int>. See Kilborn, see <http://ssrn.com/abstract=1663108>.

21. See Global Principle 13.3(iii) concerning the matter of international jurisdiction to open an insolvency case in respect of a natural person as a debtor. General on the overindebtedness of individual persons, see Niemi, Ramsey & Whitford 2009; Huls 2010 (<www.erasmuslaw review.nl>).

debate, to ensure that any aspects of the Principles that may give rise to difficulties of transposition into the legal culture of any particular state or region can be properly and sensitively considered. This approach resulted in the formation – in line with the applicable rules governing publications of the ALI – of consultative groups and in the convening of discussions and debates in many international gatherings, seminars and lectures. The consultative process was based on two questionnaires, set out in 2006 and 2007, specifically relating to the ALI NAFTA Principles and the accompanying Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases, and a third questionnaire concerned with choice of law questions.

As the Global Principles Project is a combined effort of ALI with III, the following groups were formed:

1. International Advisors, 12 in number, appointed by ALI and III, chaired by Professor Jay Westbrook, University of Texas at Austin;
2. Members' Consultative Group, formed by some 50 other ALI Members with an interest in the project;
3. III Working Group, formed by over 20 III Members with an interest in the project, chaired by E. Bruce Leonard (Toronto, Canada), Chair of III;
4. International Consultants (some 20 coming from 18 countries), consisting of recognized experts with an interest in the project, not being members of ALI or III, chaired by us as the Reporters.[22]

We have thus had the privilege of collaborating with a wide circle of international advisers who volunteered to participate, notably by supplying expert advice about the suitability (or otherwise) of the Principles for application in systems of which they have first-hand knowledge, and also by commenting on the evolving drafts of our report at various stages of its gestation. The support thus provided by our collaborators, being practitioners, scholars and judges, has enabled us to base our report on surveys of more than 30 separate jurisdictions representing a variety of legal traditions. Between summer 2006 and summer 2011 six half-day or one-day seminars were held wherein members of all the consultative groups and invited guests debated and discussed several topics of the project. These meetings were held at Columbia University (New York) on four occasions, at Humboldt University (Berlin) and in Rome (Italy).

In April 2010 the project entered into the next phase, as the Preliminary Draft of the Report of the Global Principles Project was circulated on a restricted basis among the panels of international advisors, and this text provided the focus of the meetings held in 2010 and 2011. In addition to the meetings each year of the consultative groups, certain parts of the project have been discussed at a number of academic conferences organized under the aegis of INSOL International or INSOL Europe's Academic Forum, at which one or both of the Reporters were in attendance. The latter included international conferences arranged in Scottsdale (Az., USA), Cape Town (South Africa), Shanghai (PR of China), Vancouver (Canada), Singapore and regional conferences in North America, Kelowna (Canada) and in Europe, in London (England), Barcelona (Spain), Riga (Latvia), Leiden (the Netherlands), Cologne (Germany), Helsinki (Finland), Athens (Greece), Stockholm (Sweden), Oslo (Norway) and Philadelphia (USA). Also during other occasions, Fletcher and I were able to discuss items with groups of academics, practitioners, law students and judges. The feedback from all these sessions has been particularly instructive. The final text is therefore based on the cumulative results of discussions in these meetings and suggestions communicated by individuals to the Reporters.[23] We are immensely grateful for all the assistance received.

The mechanism for decision that has been adopted by the Reporters has been the following: if any particular issue cannot be resolved on the basis of a text of universal application acceptable to all members of the consultative groups, accommodations have been sought by means of a proviso to allow the main principle to operate subject to certain necessary local modifications. In the course of this process, the extant array of internationally generated texts mentioned earlier have been studied with a view to ascertaining additional, complementary principles of law and practice that are considered to command general support. Both institutes share the aspiration that the recommendations within this report shall accurately represent a consensus shared among a large group of leading consultants from a large group of jurisdictions. Where this mechanism led to recasting the original ALI NAFTA Principles into a form suitable for fully global application, references to "NAFTA country" in the ALI-NAFTA Principles have been reformulated so that they refer to "a state which … has jurisdiction for that purpose".

On the whole, the Reporters are of the opinion that the texts of the Global Principles reflect such a consensus. No term, principle, guideline or legislative recommendation has been adopted that was substantially opposed by two or more of the consultants. The Global Principles for Cooperation in International Insolvency Cases therefore represent a truly international, global consensus among the consultants, not always reflecting unanimous agreement on every particular, but expressing agreement on fundamental values and general standards,

22. As engaging in work for ALI may create tension between the best interest of lawyers' clients and ALI's vision and philosophy, both the Reporters and all advisors and consultants (lawyers, judges, professors and other scholars) were asked to make appropriate disclosure of ways in which the position they take may be influenced by their professional obligations and relations. Altogether, the advisers and consultants, whose names are listed in the Report, originate from over thirty jurisdictions in five continents.

23. We have also consulted the larger legal community to communicate experiences or wishes to us, see, *e.g.*, Fletcher & Wessels 2010a, pp. 149-153; Wessels 2010b, p. 154.

preventing disagreement on certain matters.[24] Furthermore, the Global Principles' aim is, in general, to be compatible with the pursuit of a variety of ultimate outcomes in terms of the method of administering an insolvent estate including, if appropriate, the distribution of the debtor's worldwide assets, while ensuring the protection of creditors' rights. Given the variety of legal systems and policies and values reflected in different types of legal tradition, the Global Principles leave room for states with differing systems of insolvency law to make common cause in ensuring that the debtor's assets are administered in the most efficient way achievable, while reserving the ultimate right to determine the mode of distribution of such assets as they are able to subject to their local jurisdiction and control.

8. The Result

The Global Principles for Cooperation in International Insolvency Cases contain 37 Global Principles for Cooperation in Global Insolvency Cases and 18 Global Guidelines for Court-to-Court Communications in International Insolvency Cases, accompanied, in each case, by commentary. The commentary contains – comparative – elucidations and provides informed background on how a certain rule, including its specific terms, is applied in a certain legal context. Often the considerations at stake are outlined and balanced, whilst many times a specific chosen rule is illustrated by examples or illustrations. In this way users of the Global Principles are able to understand more fully the background and meaning of a certain rule or its application in a certain situation. The commentary forms an integral part of the Global Principles. Notes (or "Reporters' Notes") have been used to set forth or discuss legal and other sources, the legal position in certain national or regional legal systems and, where relevant, the current position on certain matters in instruments of soft law. When provided, they appear at the end of a segment of black-letter commentary. The Reporters' Notes should enable readers to better evaluate the background of certain principles and sometimes suggest avenues for further investigation or additional research.

We demonstrate in our Report that the essential provisions of the ALI's Principles of Cooperation Among the NAFTA Countries, subject to certain necessary modifications, are fully capable of acceptance in jurisdictions across the world.[25] On the other hand, the challenge of our present day should not be ignored and our ambition has been to make real progress. Professor Bufford, as reviewer on behalf of III, reported in November 2011 that he was especially pleased with some of the innovations we proposed, such as the principles on case management (Principle 4), equality of arms (Principle 5), cooperation (Principle 26) and coordination (Principle 27), while he particularly supported principles on which there is not full agreement, such as assistance to reorganization (Principle 30), limits on priorities (Principle 35), and making a plan binding on the creditors (Principles 36 and 37).[26]

To give a sense of what we regard as particularly important principles I have selected two of them, which I will briefly explain now.

8.1 Language in Cross-Border Cooperation

Global Principle 21 relates to the most important channel of communication, language. The text is as follows.

> Principle 21 Language
>
> 21.1. Where there is more than one insolvency case pending with respect to a debtor the insolvency administrators should determine the language in which communications should take place with due regard to convenience and the reduction of costs. Notices should indicate their nature and significance in the languages that are likely to be understood by the recipients.
>
> 21.2. Courts should permit the use of languages other than those regularly used in local proceedings in all or part of the proceedings, with due regard to the local law and available resources, if no undue prejudice to a party will result.
>
> 21.3. Courts should accept documents in the language designated by the insolvency administrators without translation into the local language, except to the extent necessary to ensure that the local proceedings are conducted effectively and without undue prejudice to interested parties.
>
> 21.4. Courts should promote the availability of orders, decisions and judgments in languages other than those regularly used in local proceedings, with due regard to the local law and available resources, if no undue prejudice to a party will result

In June 2011 Professor Zimmermann from the Max Planck Institute in Hamburg, Germany, delivered an address at the Inaugural Congress of the European Law Institute. He pointed at the much more difficult task of the ELI than that of the ALI as the European Union alone has 23 official languages. In addition, one is confronted too many times with improper translations into other official languages of the EU or what originally had been developed in one of the EU's working languages. Where in many other sciences, such as medicine, psychology or economics, English is the prevailing language, this is not so obvious for Europe. Twenty years

24. As Reporters, we are of the opinion that the Global Principles have as their foundation, in the words of Paul L. Friedman, Chair of the ALI Program Committee: "the Institute's traditional and primary goals: achieving coherence, reflecting current best practices, and better adapting the law to social needs", see "The President's Letter", 32 *The ALI Reporter* 2, Winter 2010, p. 3.

25. The reviewer on behalf of ALI, U.S. Bankruptcy Judge Elisabeth Stong (Eastern District of New York), was particularly helpful in suggesting comments with the goal of internal coherence and consistency with the kind of statements that ALI customarily receives or issues.

26. Prof. Bufford is a professor at Penn State (Dickinson School of Law) and former US Bankruptcy Judge – Central District of California, Los Angeles.

ago, as Zimmermann recalls, in Brussels two languages were used: good French and poor French. Now English is on the rise, not the Jane Austen or Winston Churchill English, but a simplified form of it spoken by people from the European continent, sometimes referred to as Eur-English. This language is not bad, but often simple, with a limited vocabulary, generally accepting two flaws:

- this language will only generally or imprecisely reflect notions that are very common in English, such as "comity", a "stay", providing "relief" or the use of a "trust", but in other languages may not have equivalents;
- this language does not always capture the true meaning of foreign legal terms or expressions that are common in a national legal language, such as the Dutch word *bindend advies* (a third party charged with a fully binding opinion), *goederenrechtelijke overeenkomst* (a specific requirement in transferring assets) or *financiëlezekerheidsovereenkomst* (which is one word in Dutch for a specific security contract).

It is obvious that in an international insolvency case, which involves for instance courts in the USA, Switzerland and Japan, or neighbouring courts in Bulgaria and Turkey, or courts in Canada, Guatamala and Norway, an understanding has to be in place on what language to use.

In our Report, Fletcher and I have included two recommendations, a general one and a recommendation for each individual case. Where several international non-governmental organizations and practitioners' associations have produced many best practices and soft law, but using a large variety of technical terms and expressions used in the various texts, in the Report's Appendix we have included over 150 terms and expressions to promote the development of a uniform global legal terminology.

On an individual level we have suggested Principle 21, cited above, with the heading "Language", in which the first paragraph provides:

> 21.1. Where there is more than one insolvency case pending with respect to a debtor the insolvency administrators should determine the language in which communications should take place with due regard to convenience and the reduction of costs.

This is a new Global Principle, which has no exact counterpart in the original ALI NAFTA Principles. Global Principle 21 has its origin in Europe, where under the application of the EU Insolvency Regulation, administrators have a duty to communicate in parallel cross-border insolvency proceedings. In 2007 in Europe, CoCo Guideline 10 has been designed to accommodate the choice of an agreed language for purposes of communication, which is based on international practice, convenience and agreement. Global Principle 21 is based upon this European text, which text itself found its inspiration in Article 6 of the ALI/UNIDROIT Principles of Transnational Civil Procedure 2004.

In the other paragraphs, we recommend, under certain conditions, that courts (i) should permit the use of languages other than those regularly used in local proceedings, (ii) should accept documents in the language designated by the insolvency administrators without translation into the local language, and (iii) should promote the availability of orders, decisions and judgments in languages other than those regularly used in local proceedings. Where a choice of language is made, for instance in a case between Germany and the Netherlands, a choice for German, or in a US-Brazilian case, a choice for English, we recommend that a native speaker of that language should be sensitive to the fact that the person(s) he or she is speaking to may be communicating in what is for him or her is a second or third language.[27]

8.2 Independent Intermediary

Global Principle 23 introduces an independent intermediary, a new professional function to overcome any hurdles in global communication.

> Principle 23 Communications between Courts; Intermediaries
>
> 23.1 Courts before which insolvency cases or requests to recognize foreign insolvency proceedings or requests for assistance are pending should, if necessary, communicate with each other directly or through the insolvency administrators to promote the orderly, effective, efficient and timely administration of the cases.
>
> 23.2. Such communications should utilize modern methods of communication, including electronic communications as well as written documents delivered in traditional ways. The Global Guidelines for Court-to-Court Communication, set out in Section III of these Global Principles should be employed. Electronic communications should utilize technology which is commonly used and reliable.
>
> 23.3. Courts should consider the use of one or more protocols to manage the proceedings with the agreement of the parties, and approval by the courts concerned.
>
> 23.4. Courts should consider the appointment of one or more independent intermediaries within the meaning of Global Principle 23.5, to ensure that an international insolvency case proceeds in accordance with these Global Principles. The court should give due regard to the views of the insolvency administrators in the pending insolvency cases before appointing an intermediary. The role of the intermediary may be set out in a protocol or an order of the court.

27. Acting in the spirit of achieving effective and efficient international insolvency cases will, in general, mean the use of simple and clear words spoken with careful articulation, and the avoidance of dialect words, over-sophisticated language, linguistic puns, euphemisms, topical references or nationally-derived cultural allusions that may be incomprehensible to those from outside the state in question.

23.5. An intermediary:

(i) should have the appropriate skills, qualifications, experience and professional knowledge, and should be fit and proper to act in an international insolvency proceeding;

(ii) should be able to perform his or her duties in an impartial manner, without any actual or apparent conflict of interest;

(iii) should be accountable to the court which appoints him or her;

(iv) should be compensated from the estate of the insolvency case in which the court has jurisdiction.

Principle 23 (Communications between Courts; Intermediaries) has been developed from Procedural Principle 10 of the ALI NAFTA Principles and takes as a starting point that communications through courts in different states take place directly or through the respective insolvency administrators, under appropriate circumstances by using electronic means, including teleconferencing, electronic mail or video-link conferencing, sometimes with the use of a written framework that expresses the objectives of the cooperative process on which the respective courts, together with all parties in interest, are engaged. Global Principle 23.4 recommends a court to "consider the appointment of one or more independent intermediaries within the meaning of Global Principle 23.5, to ensure that an international insolvency case proceeds in accordance with these Global Principles".

In the reality of everyday life under certain circumstances the court may wish to refrain from conducting direct communications with another foreign court, or even from doing so through the insolvency administrators who are conducting the respective proceedings in the states concerned. Reasons for considering such a course of action could be simply the unavailability of such e-technological means, especially in smaller, local courts. A more obvious consideration may be the anticipated complexity of multilingual communications in different time-zones, with more than two insolvency cases pending simultaneously (e.g. in such cases as *Madoff* or *Lehman Brothers*). Some may even think that cross-border communication with courts and administrators in three jurisdictions is simply impossible. Another reason could be the court's genuine desire to maintain full impartiality, particularly if there are perceived to be conflicts between the administrators. In any such case the court could consider appointing an independent intermediary.

An intermediary's general task is to help ensure that an international insolvency case is operated in accordance with these Global Principles and with any specific provisions that are either set out in a protocol or specified in the order made by court, see Global Principle 23.4. third line. The court should give due regard to the views of the insolvency administrators in the pending insolvency cases before appointing an intermediary, see Global Principle 23.4. second line. Global Principle 23.5. sets out the intermediary's legal position and sets some professional and ethical rules for his role.

The role of an independent intermediary is new compared with the ALI NAFTA Principles, but the appointment of an independent intermediary fully fits within the structure of Articles 25-27 UNCITRAL Model Law,[28] whilst the UNCITRAL Legislative Guide of 2010 has adopted the figure of a "court representative" having a similar function as an intermediary.[29]

9. Conclusion

The goal of the Global Principles is not to provide a complete charter for law reform. We believe we can fairly claim that our Report fulfils the commission ALI and III entrusted to us. We believe too that we have further built on the existing ALI Principles and the useful "soft law" work done by other organizations and drafted Global Principles that are tangible, practical and realistic. The main goal of the ALI and the III is for the Global Principles to provide a standard statement of principles suitable for application on a global basis in international insolvency cases. As in the ALI NAFTA Principles, a "principle" is a statement of value serving as a guideline for behaviour in cross-border insolvency cases. While the Global Principles are linked to the ALI NAFTA Principles, the present Report is to be regarded as an independent text.

Fletcher and I think that the Global Principles may serve several purposes. They are worded in language that permits courts to apply them in a flexible way, tailored to the specific circumstances of each individual case. Where the Global Principles reflect a non-binding statement, we have chosen – contrary to several examples of soft law documents – not to include words such as "to the maximum extent possible" or "as far as possible", which allows the application of any national rule with which a given principle would conflict.

The Global Principles may serve as an indication for insolvency office holders of the best, or preferred, approach in cross-border cases. Both for judges (and sometimes arbitrators) and for practitioners, the Global Principles may apply in cases where (international) insolvency legislation has been formulated in general, open terms or provisions or in cases where the existing body of binding legislation does not cover a specific matter.

Furthermore, the Global Principles may serve as non-binding codified customs and norms that may assist in preparing legal advice, in drafting contracts or in mat-

28. Art. 27(a) Model Law allows a court to implement cooperation by any appropriate means, including the appointment of a person or body to act at the direction of the court.

29. A court representative is a person who may be appointed by a court to facilitate coordination of insolvency proceedings concerning enterprise group members taking place in different jurisdictions, see *UNCITRAL Legislative Guide, Part Three: Treatment of Enterprise Groups* 2010, para. 37.

ters of interpretation. They may therefore indicate an alternative or a solution in cases where it proves to be impossible to determine a specific rule of the law applicable or the law relating to (insolvency) proceedings. In this way too the Global Principles may stimulate convergence and coherence between several regional or national legal systems.

We also are of the opinion that the Global Principles could assist as a model or a guide for national or regional legislators.[30]

Finally, it is suggested that the Global Principles could form a part of courses and classes in academia all over the world and in post-graduate programs (of continuing education), so students and other interested professionals could be taught some of the principles that guide or steer international approaches. Both Fletcher and I firmly believe that the true aspiration for cooperation in international insolvency cases will be stimulated by educating younger generations within the spirit that the Global Principles aim to reflect: the embodiment of what is globally perceived as the best solution in certain matters of international insolvency cases.

In these ways it is hoped that, as embodied in the final text, the Global Principles possess persuasiveness, as they are supported by a large global consensus, and will obtain the approbation of governmental authorities, domestic and international organizations, practitioners, and (most importantly) courts in their search for suitable solutions and their approach to the conduct of international insolvency matters in the future.

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30. In relation to Europe, the Global Guidelines could be considered in the context of the work following from the European Parliament resolution of 15 November 2011 with recommendations to the European Commission on insolvency proceedings in the context of EU company law (2011/2006(INI)).

Revisiting China's Merger Control

Where Are We Going After the Three-Year Milestone?

Xinzhu Zhang & Vanessa Yanhua Zhang*

1. Introduction

After thirteen years of incubation, the Chinese government eventually enacted the Anti-Monopoly Law (hereinafter AML), yet at a time when China's economy was still in transition from a centrally planned economy to a market economy. Discussion of China's experience in antitrust is important in at least two respects. On the one hand, as a country with newly established antitrust regimes, its experience will certainly contribute to the understanding of antitrust issues among antitrust agencies in other jurisdictions all over the world. On the other hand, and perhaps more importantly, due to the unique experience that China has achieved remarkable economic successes in the absence of a comprehensive competition law, it will contribute to both policy and academic debates clarifying whether antitrust has any role to play in promoting economic development.[1]

Similarly to the competition laws in other jurisdictions, the AML consists of three bodies of substantive legal rules against monopolistic/collusive agreements, abuse of dominance conduct, and anticompetitive merger and acquisitions. However, while it has been three years since the AML came into effect, on 1 August 2008, its enforcement has developed slowly and unevenly. Merger control is probably the most advanced enforcement area. For example, several hundreds of cases have been completed by the Anti-Monopoly Bureau of the Ministry of Commerce (MOFCOM), China's merger review agency, and several high-profile cases have been decided. Thus, it may be more valuable to review the enforcement of AML with a focus on merger control. As the cases have accumulated and more decisions have been released, it is a good time to take stock and revisit the question: where are we going after the three-year milestone?

In a previous paper, published in 2010,[2] we have discussed the patterns of China's merger control policy and tried to provide some implications on what we could look forward to. Since its publication, there have been some new developments in the merger control policy in China. To begin with, many new cases have been reviewed. According to MOFCOM,[3] from 1 August 2008 to the end of December 2011, it has completed merger reviews of 382 cases, with seventeen cases in 2008, 80 in 2009, 117 in 2010 and 168 in 2011. Among those 382 completed cases, 371 were cleared by MOFCOM without any condition, which account for 97% of the total number of closed cases. Ten cases were approved with conditions and one was blocked, which account for 3% of the total. From analyzing those case decisions, we find that although the rules and provisions of China's merger control policy are largely consistent with those of other jurisdictions such as the US and the EU, MOFCOM takes its own approach to reviewing mergers and making decisions.

The rest of this article is organized in the following way: Section 2 analyzes the merger review regulations; Section 3 discusses the eight cases that were released during the period September 2009-June 2011.[4] Section 4 provides a preliminary analysis of those cases. In Section 5 we try to shed some light on the patterns and implications of China's merger control policy and Section 6 concludes the discussion.

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1. See Ulen 2010.
2. See Zhang & Zhang 2010, pp. 477-496.
3. See Zhang 2011, available at <www.gov.cn/jrzg/2011-09/21/content_1953353.htm>. See also MOFCOM Press Release, "MOFCOM Held a Press Conference on 2011 Review of Antitrust Enforcement", 31 December 2011, available at: <http://english.mofcom.gov.cn/aarticle/subject/cv/lanmua/201112/20111207909371.html>. MOFCOM Press Release, "MOFCOM Held a Press Conference on the Interim Measures for Investigating and Publishing of Concentration of Undertakings Failing to File Notification", 10 January 2012, available at <www.gov.cn/jrzg/2012-01/10/content_2041384.htm>.
4. For the discussion of the cases that were released during August 2008 and August 2009, please refer to another article written by us: Zhang & Zhang 2010.

2. Recent Regulations on Merger Reviews

2.1 The Market Definition Guidelines

In terms of regulations and rules for implementation of the AML, the Competition Commission of the Chinese State Council issued the first antitrust guidelines, *i.e. The Guidelines on the Definition of Relevant Market* (the Market Definition Guidelines), on 7 July 2009.[5] The Guidelines incorporate and integrate some concepts and principles from the horizontal and non-horizontal merger guidelines issued in other jurisdictions, such as the US and the EU. As usual, they also contain certain Chinese characteristics. They also bear some similarity to the US Horizontal Merger Guidelines, released by the US Department of Justice and Federal Trade Commission on 19 August 2010 (the 2010 US Horizontal Merger Guidelines),[6] and the EU Horizontal Merger Guidelines.[7] The guidelines were issued by the Competition Commission of the State Council rather than any of the three antitrust enforcement agencies. This implies that these guidelines are applicable not only to merger review but also to investigation of monopolistic agreement and abuse of dominance conduct. This treatment is similar to the approach in both the US and the EU and has the advantage of coherence in dealing with different types of cases. However, the Market Definition Guidelines fail to mention the caveats applying to different types of cases, for example, the benchmark price issue that was caused by pre-merger market power. It thus casts a shadow on how to solve such technical problems in case investigation in order to avoid important issues, such as the Cellophane Fallacy.

2.2 The Interim Rules

Two years after the Market Definition Guidelines were announced and one year after the US released the 2010 Merger Guidelines, MOFCOM published *the Interim Rules on the Assessment of Competitive Impacts of Concentrations of Undertakings* (the Interim Rules), which took effect on 5 September 2011.[8]

The Interim Rules provide the road map on how MOFCOM will assess mergers or other concentrations under the AML. The Interim Rules possess several notable features. First, the Market Definition Guidelines and the Interim Rules have been treated with different legal approaches. The former were issued by the Competition Commission of the State Council as guidelines, whereas the latter were enacted by MOFCOM as regulatory rules. Second, Article 4 of the Interim Rules states that two types of competition harms for horizontal mergers will be considered: the unilateral effect and the coordinate effect. Such an approach is similar to those in the US and the EU. In addition, Article 4 states that competition harm for non-horizontal mergers will also be taken into account. From this perspective, one may conclude that China's approach to assessing competition effects of non-horizontal mergers is closer to that of the EU than to that of the US, where competition effects for non-horizontal mergers are obviously downplayed. However, there is one major difference between the Chinese and the European approaches: in the EU, a higher standard of proof for non-horizontal mergers is explicitly required, which is consistent with modern economic theory. In China, however, the issue of standard of proof for non-horizontal mergers is not mentioned explicitly. This might cause more non-horizontal mergers to be blocked or approved with remedies if lower standards of proof were imposed.

3. Recent Cases

As we have mentioned in the introduction, three cases that were closed between August 2008 and August 2009 have been discussed in one of our previous articles, namely InBev/Anheuser-Busch, Mitsubishi Rayon/Lucite, and Coca-Cola/Huiyuan.[9] We will thus cover mainly the eight cases that were closed during the period September 2009-December 2011. Those eight cases include GM/Delphi, Pfizer/Wyeth, Panasonic/Sanyo, Novartis/Alcon, Uralkali/Silvinit, Alpha V/Savio, and GE/Shenhua Joint Venture.

3.1 GM/Delphi

On 18 August 2009, the US auto manufacturer, General Motors (GM) notified MOFCOM of its proposed acquisition of the US auto parts producer, Delphi. In fact, Delphi used to be a part of GM but divested away and became a fully independent publicly held corporation in 1999 in the midst of globalization and specialization in the industry. Since then, GM's parts purchase from Delphi has reduced sharply from 80% to about 11% in 2008, although Delphi has continued to be GM's largest parts supplier. One special feature about this merger case is that Delphi has been in bankruptcy protection since 2005 because of industrial slowdown and rising costs.

MOFCOM released the case decision on 28 September 2009.[10] MOFCOM took the position that both Delphi and GM were the leading firms in the relevant markets. However, the term "market dominance" was not used and no information on market structure was available.

5. See the State Council of People's Republic of China Press Release, *The Guidelines on the Definition of Relevant Market*, 7 July 2009, available at: <www.gov.cn/zwhd/2009-07/07/content_1355288.htm>.
6. The revised 2010 US Horizontal Merger Guidelines are available at <www.justice.gov/atr/public/guidelines/hmg-2010.html>.
7. See EU Horizontal Merger Guidelines, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52004XC0205%2802%29:EN:HTML>.
8. See MOFCOM Notice No. 55 [2011], Interim Rules on Assessment of Competitive Impacts of Concentrations of Undertakings, 29 August 2011, available at: <http://fldj.mofcom.gov.cn/aarticle/zcfb/201109/20110907753173.html>.
9. See Zhang & Zhang 2010.
10. See MOFCOM GM/Delphi Decision, Notice No. 76 [2009], 28 September 2009, available at: <http://fldj.mofcom.gov.cn/aarticle/ztxx/200909/20090906540211.html>.

Because of the merging parties' influence in each relevant market, MOFCOM was concerned mainly about the vertical foreclosure of various Chinese auto manufacturers brought about by the reconstructed vertical relationship post-merger and the fact that Delphi was the major supplier for them. MOFCOM was also worried that market entry might be more difficult for other Chinese auto parts suppliers to deal with GM after the merger.

Eventually, MOFCOM imposed behavioural remedies that GM/Delphi should continue to supply Chinese auto manufacturers on a non-discretionary basis and should not exchange confidential information related to any third party; they should cooperate with its customers to facilitate the switch to other auto parts suppliers; GM's purchase should be diversified and GM should be non-discriminatory when purchasing auto parts from other suppliers.

3.2 Pfizer/Wyeth

On 9 September 2009, the US pharmaceutical giant Pfizer submitted its notification for approval of its proposed acquisition of another US pharmaceutical company, Wyeth. In fact, this merger was proposed at a time when the pharmaceutical giants around the world were all facing a similar problem of expiration of their major patented drugs. For example, Pfizer's most popular drugs in terms of prescription volumes, the anti-hypertension and anti-anginal drug, Norvasc, the allergy treatment medicine, Zyrtec, and the anti-cancer drug, Camptosar, had all expired in 2008. In addition, its star drug, Lipitor, the cholesterol lowering drug, was also due to expire in 2010. Similarly, Wyeth's major patented drugs, the anti-depressant, Effexor, and the anti-high blood pressure drug, Protonix, were to expire soon. Under these circumstances, the consolidation was one of the important means of strengthening the firm's financial position. In fact, post-merger, Pfizer-Wyeth would become the largest pharmaceutical company in the world.

On 29 September 2009, MOFCOM conditionally approved the global acquisition of Wyeth by Pfizer.[11] Interestingly, instead of following other jurisdictions' lead, the decision was made ahead of approval from the US Federal Trade Commission, Australian ACCC and the Canadian Competition authority. The main competition concern centred on the swine mycoplasmal pneumonia vaccine business. Indeed, MOFCOM was worried about the post-merger market share of the two companies (49.4%) and increased market concentration (post-merger HHI 2182, ΔHHI = 336). In fact, it is one of the few cases where more detailed information on the relevant market structure was released. Meanwhile, MOFCOM considered there to be a significant entry barrier problem. Therefore, MOFCOM ordered the divestiture of Pfizer's swine mycoplasmal pneumonia vaccine business.

3.3 Panasonic/Sanyo

MOFCOM received the notification of the proposed acquisition of Sanyo Electric Co. (Sanyo) by Panasonic Corporation (Panasonic) on 21 January 2009. The two Japanese companies were major international producers of electronics products, and China was the major manufacturing base for both Sanyo and Panasonics. Their product lines included many kinds of consumer electronics with famous brands. To a great extent, the two Japanese companies had overlapping product lines. But the chief strength of Panasonic was in consumer electronics, and Sanyo was the world leader in various types of new energy cells such as solar cells, fuel cells and chargeable cells. The consolidation would strengthen Panasonic's competitiveness in solar cells and make it the world leader in R&D in new energy cells on the whole.

MOFCOM cleared this case with conditions on 30 October 2009.[12] Interestingly, it is one of the released cases that have entered Phase III. MOFCOM's antitrust review focused on three lines of products: highly concentrated button batteries, civil batteries, and vehicle batteries, which were defined as relevant product markets. MOFCOM revealed that post-merger, the merging parties would have combined global market shares of 61.6%, 46.3% and 77% in the relevant markets, respectively. Based on this market share information, MOFCOM concluded that the relevant markets were highly concentrated and that the merging party would cause competition harm by raising prices unilaterally.

MOFCOM ordered substantial business divestiture in all three markets: (1) for button batteries, Sanyo should divest all its business to an independent third party; (2) for civil batteries, MOFCOM let the merging parties decide whose business would be divested but that divestiture of one party's business would be sufficient; and (3) for vehicle batteries, since Panasonic and Sanyo had high market shares and were essentially the only two firms in this market, Panasonic was, in addition to business divestiture, ordered to reduce its shareholding in Panasonic EV Energy Co. (PEVE), a joint venture between Panasonic and Toyota, from 40% to 19.5% in order to maintain competition in this market. Besides, to reduce its control of the joint venture by Panasonic, it should also waive its voting rights at PEVE's Shareholders Meeting, its right to appoint directors to the Board, and veto power regarding PEVE's battery business.

3.4 Novartis/Alcon

On 20 April 2010, MOFCOM received notification from the merging parties of the proposed acquisition of Alcon by Novartis, both Swiss pharmaceutical compa-

11. See MOFCOM Pfizer/Wyeth Decision, Notice No. 77 [2009], 29 September 2009, available at: <http://fldj.mofcom.gov.cn/aarticle/ztxx/200909/20090906541443.html>.

12. See MOFCOM Panasonic/Sanyo Decision, Notice No. 82 [2009], 30 October 2009, available at: <http://fldj.mofcom.gov.cn/aarticle/ztxx/200910/20091006593175.html>.

nies.[13] In fact, Novartis was the seventh largest pharmaceutical company globally while Alcon, owned by the giant food producer, Nestle, was the largest producer of eye-care products in the world. Again, the merging transaction was proposed at a time when Novartis was facing the thorny problem of the expiration of its patented drugs and increasing competitive pressure from generic drug producers. Indeed, the consolidation was consistent with the worldwide trend of diversification in the pharmaceutical industry. Meanwhile, Nestle's decision to sell Alcon was reflective of its moving in the direction of focusing on its competitive strength – food production.

MOFCOM conditionally cleared the proposed acquisition on 13 August 2010, just a day before the end of Phase II.[14] MOFCOM found that the proposed acquisition would raise anti-competitive concerns in the ophthalmological anti-infective, anti-inflammatory/anti-infective combinations market and in the contact lenses care products market. It seemed that this conclusion was largely based on the relevant market share information. Indeed, in the ophthalmological anti-infective, anti-inflammatory/anti-infective combinations market, Alcon's market share in China, which was likely to be the geographical market mainly because of international transfer pricing, a common practice in the pharmaceutical industry, was over 60%, although Novartis had less than 1% of the market share in China.[15] Interestingly, Novartis demonstrated its strategic decision to exit the global market as well as the China market. However, MOFCOM did not consider this strategic plan sufficient to ensure future market competition. It thus ordered that Novartis cease sales of its ophthalmological anti-infective, anti-inflammatory/anti-infective combinations under current brands in China and not sell such products under the same or different brands in the Chinese market for the following five years.

In the contact lenses care product market, MOFCOM showed that the combined market shares of Novartis and Alcon would be 60% globally and 20% in China post-merger. MOFCOM also revealed that Novartis had a distribution agreement with the largest contact lenses manufacturer, Hydron Contact Lens Co. Ltd. (Hydron), the largest seller and producer in China, whose production accounted for over 30% of the contact lenses care market in China. MOFCOM was worried that this agreement would facilitate post-merger coordination between Novartis/Alcon and Hydron on price, quality and sales territories of contact lenses care products. Therefore, Novartis was ordered to terminate its distribution agreement with Hydron within twelve months after the decision was released.

3.5 Uralkali/Silvinit

The proposed acquisition of Silvinit by Uralkali, the two major potash fertilizer producers and the world's leading exporters based in Russia, was filed with MOFCOM on 14 March 2011. Both are vertically integrated companies with control of the whole production chain, from potash ore mining to supply to ultimate consumers, and China was one of the main export markets. Interestingly, this case raised the keen attention of observers of China's antitrust enforcement because of the extraterritorial jurisdiction issue involved. Indeed, the case decision was released in the midst of a heated debate over this complicated issue when the proposed acquisition of the Rio Tinto Group (Rio Tinto) by Broken Hill Proprietary Billiton Ltd. (BHP Billiton), two of the three largest iron ore producers and exporters based in Australia, was announced and discussed.

On 2 June 2011, MOFCOM released a conditional approval of this merger case.[16] This paved the way for the extraterritorial enforcement of the AML. MOFCOM defined the relevant product market as potassium chloride with a global geographical market. MOFCOM found that the potassium chloride market was highly concentrated simply because its production was controlled by a few big companies. Indeed, more than 80% of the global reserves were held by the top three producing countries. The merged company, Uralkali/Silvinit, would emerge as the second largest exporter of potassium chloride with over a third of the global market. In addition, the combined global market share of the top two companies would be over 70%. Moreover, until recently China had been highly dependent on the international potassium chloride market with over 50% of the importation of potassium chloride depending on Uralkali/Silvinit or their associated companies.

The increased concentration post-merger raised MOFCOM's concerns on the Uralkali/Silvinit's increased market power through the ownership of more potassium resources and stronger production capacity in the wake of increasing demand from China and other booming economies. MOFCOM was at the same time concerned about the anti-competitive coordination between the fewer suppliers remaining in the global market. Meanwhile, MOFCOM identified that barriers to entry into the potassium chloride market would be high due to the scarcity of exploitable potassium reserves and massive assets and time required to expand the existing facilities or to explore new mines. Eventually, MOFCOM proposed a behavioural remedy and ordered the Uralkali/Silvinit to continue providing the whole range of potassium chloride products to its Chinese clients in sufficient quantities, to maintain the cur-

13. In fact, it was only the second step of the acquisition agreement between Novartis and Nestle signed in April 2008. As the first step, Novartis bought 25% of Alcon's shares in the second half of 2008. Novartis would acquire 52% more shares of Alcon from 1 January 2010 to 31 July 2011. But for the acquisition in the first step, the merging parties may not need to notify the antitrust agency for antitrust review because it may not constitute a merger.
14. See MOFCOM Novartis/Alcon Decision, Notice No. 53 [2010], 13 August 2010, available at: <http://fldj.mofcom.gov.cn/aarticle/ztxx/201008/20100807080639.html>.
15. Globally, although there is no market share information on individual firms, the combined market share post-merger would be 55%.
16. See MOFCOM Uralkali/Silvinit Decision, Notice No. 33 [2011], 2 June 2011, available at: <http://fldj.mofcom.gov.cn/aarticle/ztxx/201106/20110607583288.html>.

rent sales method and process as well as customary negotiation procedures by taking into account the historical and current trading situation with its Chinese clients and the characteristics of the Chinese market. It further stipulated that a monitoring trustee be appointed by the merged party to ensure compliance with the commitments and report to MOFCOM on their implementation.

3.6 Alpha V/Savio

On 14 July 2011 MOFCOM received notification of the acquisition of Savio Macchine Tessili S.p.A. (Savio), an Italian textile manufacturer, by Penelope S.r.l. (Penelope), wholly controlled by Alpha Private Equity Fund V (Alpha V). MOFCOM officially initiated Phase I review on 5 September 2011.

The focus of the competition analysis fell into a narrowly defined product market – the "auto-winder electronic yarn clearer market". As the wholly controlling shareholder of acquirer Penelope, Alpha V holds 27.9% of the shares in Uster Technologies Ltd. (Uster). Meanwhile, Loepfe Brothers Ltd. (Loepfe) is the wholly owned subsidiary of the target company, Savio. According to MOFCOM, both Uster and Loepfe are the only two manufacturers in the world of automatic winder electronic yarn clearers. Their global market shares in 2010 were 52.3% and 47.7%, respectively. Their shares of the Chinese market were quite similar.

On 31 October 2011, MOFCOM conditionally approved the acquisition.[17] It was concerned about the possibility that the two competitors, Uster and Loephe, may coordinate their business activities via Alpha V post-merger, which in turn would restrict and eliminate competition in the relevant market. Meanwhile, MOFCOM analyzed market entries and found that there existed substantial entry barriers for new participants due to capital and R&D investments. Therefore, MOFCOM ordered Alpha V to divest its shares in Uster to an independent third party within 6 months after the decision and refrain from participating in or influencing Uster's operations and management before the divestiture was completed. The whole divestiture process shall be supervised by a monitoring trustee appointed by Alpha V.

3.7 GE/Shenhua Joint Venture

On 13 April 2011, MOFCOM received notification of formation of a joint venture between GE China and Shenhua, a state-owned enterprise (SOE). The proposed transaction was initially announced in January 2011.[18] MOFCOM officially started the Phase I review on 16 May 2011. With two extensions, one on 15 June and the other on 13 September, MOFCOM finally announced its decision on 10 November 2011, almost at the end of the Phase III review. In this proposed transaction, GE China and Shenhua are to establish a 50/50 joint venture (JV) to license coal-water slurry (CWS) gasification technology to industrial and power projects in China. GE Infrastructure Technology, a subsidiary of GE, will provide GE's CWS gasification technology to the proposed JV. Meanwhile, Shenhua is the largest supplier of the coal used for gasification and also possesses businesses such as electricity generation, rail and port transportation, coal chemical engineering, etc. This JV will integrate GE's technology and experience and Shenhua's coal resource.

MOFCOM cleared the proposed JV with conditions on 10 November 2011.[19] It was worried that the CWS gasification technology licensing market is highly concentrated, within which GE Infrastructure Technology and another two Chinese institutions are major players. Among the top three players, GE's market share is the highest. Meanwhile, MOFCOM investigated the upstream market and found that CWS gasification technology requires specific raw coal, which makes operation of CWS gasification technology heavily dependent on supply of such raw coal. In fact, MOFCOM identified Shenhua as the largest supplier of raw coal in 2010, though no market share information was provided. In particular, it was unclear whether Shenhua had a dominant position in the relevant market of the specific coal for CWS gasification technology. MOFCOM was thus concerned about the vertical competition effect; in other words, that the merged party may foreclose its competitors by taking advantage of its market position in the supply of the specific coal. In addition, MOFCOM conducted entry analysis and found entry barriers to the CWS gasification technology market are quite high due to technological complexity, intellectual property rights and long R&D and industrialization cycle.

Eventually, MOFCOM issued behavioural remedies and ordered the JV partners not to require customers to use only the JV technology, or not to increase the cost of using competing technologies by either limiting the supply of specific raw coal or by imposing conditions on the coal supply. Interestingly, this was the first joint venture case that has received serious antitrust review and was approved conditionally.

3.8 Seagate/Samsung

On 12 December 2012 MOFCOM imposed conditions on the Seagate/Samsung merger.[20] The review of the merger was initiated on 13 June 2011 after the draft notification was first submitted to MOFCOM on 19 May 2011. After an in-depth investigation and consultation with external experts, MOFCOM concluded that the Seagate/Samsung merger would cause compe-

17. See MOFCOM Alpha V/Savio Decision, Notice No. 73 [2011], 31 October 2011, available at: <http://fldj.mofcom.gov.cn/aarticle/zcfb/201111/20111107809156.html>.

18. See GE Press Release, "GE and Shenhua Announce Formation of Cleaner Coal Technology Joint Venture in China", 18 January 2011, available at: <www.genewscenter.com/Press-Releases/GE-and-Shenhua-Announce-Formation-of-Cleaner-Coal-Technology-Joint-Venture-in-China-2ddd.aspx>.

19. See MOFCOM GE/Shenhua Decision, Notice No. 74 [2011], 10 November 2011, available at: <http://fldj.mofcom.gov.cn/aarticle/zcfb/201111/20111107824342.html>.

20. See MOFCOM Seagate/Samsung Decision, Notice No. 90 [2011], 12 December 2011, available at: <http://fldj.mofcom.gov.cn/aarticle/zcfb/201112/20111207874274.html>.

tition harm owing to anti-competitive coordinated effects. In the competition analysis, MOFCOM stated that the reduction in the total number of competitors would have enabled the remaining competitors to coordinate their conduct in the particular circumstances of the market. Given the relatively high market concentration with five players worldwide, where Seagate's market share was 33%, Western Digital's 29%, Hitachi's 18%, Toshiba's 10% and Samsung's 10%, MOFCOM found that the product, namely hard disk drive (HDD), is homogeneous and market competition transparent.

MOFCOM then imposed behavioural remedies on the proposed transaction. It ordered the merging parties to maintain Samsung HDD as an independent competitor, set up an independent subsidiary to price and market Samsung's products and build a Chinese wall to avoid information exchange between Seagate and the Samsung subsidiary competitor. Meanwhile, Seagate should increase its capacity to produce Samsung HDD within 6 months after the decision and not change its current business model or force its customers to purchase exclusively from Seagate or its affiliates. Moreover, Seagate should not require TDK (China), an independent supplier, to supply HDD heads to Seagate and its affiliates on an exclusive basis, or restrict TDK's supply to other producers. Seagate should promise to invest at least US $800 million each year during the next 3 years to promote innovation and benefit customers with more innovative products and business solutions. MOFCOM also ordered Seagate to appoint a trustee to monitor compliance.

4. Preliminary Case Analysis

In the merger cases that MOFCOM released, there are horizontal and non-horizontal mergers. Although horizontal and non-horizontal mergers seem to be treated similarly in the Interim Rules,[21] economic theory and practices in other jurisdictions suggest that the fundamental problems with these two types of mergers differ and that the standards of proof are also different. Therefore, we discuss these mergers separately.

4.1 Horizontal Mergers

Under the AML, the legal principle for merger review is to evaluate whether a merger may restrict or exclude competition, which is consistent with international practice.[22] However, since many important implementing rules in the Market Definition Guidelines and the Interim Rules are simply too vague, the enforcement has some Chinese characteristics.

4.1.1 Market Definition

In most cases, MOFCOM had a clear definition of relevant product markets. For example, in the cases of Pfizer/Wyeth,[23] Panasonic/Sanyo[24] and Novartis/Alcon,[25] multiple relevant product markets were defined. As to the relevant geographical markets, however, MOFCOM was not always clear. In the Pfizer/Wyeth[26] case, for example, MOFCOM clearly defined China as the geographic market. But in the case of Novartis/Alcon,[27] it was not clear whether the world market or China was defined as the relevant geographic market.

An interesting question is, what has been the main approach that MOFCOM has used to define relevant markets? From the information released, it seems that MOFCOM has depended mostly on a qualitative economic approach, which is to analyze demand and supply substitutability, as required in the Market Definition Guideline.[28] For example, there is no indication that they have ever used the Critical Loss Analysis, a common method to implement the SSNIP test in many jurisdictions, or more generally, the quantitative economics approach, to define relevant markets.

4.1.2 Market Power

Market power is the pre-condition for any merger to create competition harm. The AML and the Interim Rules have specified the legal principles to infer market power. But they fail to provide detailed rules on how to implement in practice. This would definitely leave some legal uncertainties.

Indeed, market share is one of the most important calibrations that have been used by MOFCOM in the merger reviews. In particular, MOFCOM is more concerned with market shares that are close to or over 50%. In the Pfizer/Wyeth[29] merger, for example, MOFCOM found that the combined post-merger market share of Pfizer and Wyeth would be 49.4% in the swine mycoplasmal pneumonia vaccine market (Pfizer 38%, Wyeth 11.4%), which is considered significantly higher than that of their nearest rival Intervet (18.35%) and other individual competitors (less than 10%). With such a post-merger market share, MOFCOM was worried that the merging parties would have the ability or the market power to expand the market and unilaterally raise the price.[30]

Besides market share, MOFCOM has also taken into account market concentration as another important calibration of market power. For example, in the Pfizer/Wyeth[31] merger, MOFCOM released the post-merger HHI 2182 and the change of HHI pre- and post-merger ΔHHI 336. With this market concentration information, MOFCOM concluded that the swine mycoplasmal pneumonia vaccine market in China is highly concentrated and that this proposed transaction would have an anti-competitive effect.

21. See the Interim Rules, *supra* note 8.
22. See the US Horizontal Merger Guidelines, and the EU Horizontal Merger Guidelines, *supra* notes 6 and 7.
23. See MOFCOM Pfizer/Wyeth Decision, *supra* note 11.
24. See MOFCOM Panasonic/Sanyo Decision, *supra* note 12.
25. See MOFCOM Novartis/Alcon Decision, *supra* note 14.
26. See MOFCOM Pfizer/Wyeth Decision, *supra* note 11.
27. See MOFCOM Novartis/Alcon Decision, *supra* note 14.
28. See Art. 4 of the Market Definition Guidelines, *supra* note 5.
29. See MOFCOM Pfizer/Wyeth Decision, *supra* note 11.
30. *Id.*
31. *Id.*

The use of market share and concentration seems to establish the legal approach for MOFCOM to presume market power. But since there are no safe harbours specified in the Interim Rules, one may wonder what has been the basis for MOFCOM to treat this information in practice. One possibility is that they might have used the benchmarks from other jurisdictions such as the EU and the US.[32] Another possibility is that they might have used the market share thresholds in Article 19 of the AML, which is used to assess abuse of dominant conduct. But this raises the question whether the same standard of proof for presuming market power should be adopted for these different types of anti-competitive conduct. Besides, one may wonder how the rebuttal process, if there is any, would be carried out in practice.

4.1.3 Competition Effects

The Interim Rules stipulate in Article 4 that two types of competition harm will be considered for antitrust review of horizontal mergers.[33] These are the unilateral effect and the coordinate effect. Such legal rules are consistent with economic theory and international practice. However, the Interim Rules were silent on whether there is any difference in the assessment of these two types of competition harm. In particular, they failed to specify how to assess the unilateral effect in a differentiated product market. For example, the Interim Rules gave no indication whether the diversion ratio should be emphasized in addition to market share and concentration information.

In the horizontal merger cases, MOFCOM was concerned about the presence of unilateral price and/or non-price effects. As analyzed previously, MOFCOM has to presume this type of competition harm based mainly on market share and/or concentration information. But one problem might be that it has placed undue emphasis on post-merger market share or concentration ratio instead of the change of market structure. In the Novartis/Alcon[34] case, for example, although Novartis had a market share of over 60% in China's ophthalmological anti-infective, anti-inflammatory/anti-infective combinations market, Alcon's market share was only less than 1%. In other words, the merger would not cause lessening of competition in this market due to Alcon's negligible market share.

In the cases of Novartis/Alcon[35] and Uralkali/Silvinit,[36] however, MOFCOM was worried about not only the unilateral effect but also coordinate effect. In particular, MOFCOM considered only the coordinate effect in the contact lenses care products market in the Novartis/Alcon[37] case, but was concerned about both types of competition effects in the Uralkali/Silvinit[38] case. In considering coordinate effect, it seems that MOFCOM has depended largely on the combined share of the two or three largest firms. However, from the information released by MOFCOM, it was not clear whether the market would become not only more concentrated but also more symmetric.

4.1.4 Counter-Factors to Market Power

Even though market share and concentration information have been used to presume market power and competition harm, counter-factors to market power were also considered, perhaps to a lesser extent.

4.1.4.1 Entry

In all cases, MOFCOM has conducted a brief entry analysis. In general, MOFCOM focused on industrial specifics such as contractual relationship (GM/Delphi[39]), economies of scale (GM/Delphi[40]), switch costs (Panasonic/Sanyo[41]), intellectual property rights (Pfizer/Wyeth[42], Panasonic/Sanyo[43], Novartis/Alcon[44] and Alpha V/Savio[45]), monopoly of natural reserves (Uralkali/Silvinit[46] and GE/Shenhua[47]) etc., to assess whether there were significant entry barriers. The interesting question seems to be: although the Interim Rules have specified the principles to conduct entry analysis,[48] which emphasize that entry must be possible, timely and sufficient, why have there not been specific rules on how to implement these principles? In particular, it is unclear what constitutes the standard of proof for the presence or absence of significant entry barriers.

4.1.4.2 Buyers' Power

MOFCOM also considers buyers' power in merger reviews to assess whether it will outweigh the increased market power caused by the proposed mergers. For example, in the Panasonic/Sanyo merger, MOFCOM found that buyers' power is not strong enough to offset the anti-competitive effect.[49] Although some large downstream users may have bargaining power while dealing with the merged entity, the countervailing effect cannot be extended to small and medium-sized users who do not possess such power.

32. In EU, the Commission would not identify horizontal competition concerns "in a market with a post-merger HHI below 1,000". It would not identify horizontal competition concerns "in a merger with a post-merger HHI between 1,000 and 2,000 and a delta below 250, or a merger with a post-merger HHI above 2,000 and a delta below 150", except certain special circumstances listed. See Arts. 19-20 of the EU Horizontal Merger Guidelines, *supra* note 7. In the US, antitrust enforcement agencies would consider mergers resulting in an unconcentrated market, *i.e.* HHI below 1,500, "are unlikely to have adverse competitive effects and ordinarily require no further analysis". See the 2010 US Horizontal Merger Guidelines, *supra* note 6.
33. See Art. 4 of the Interim Rules, *supra* note 8.
34. See MOFCOM Novartis/Alcon Decision, *supra* note 14.
35. *Id*.
36. See MOFCOM Uralkali/Silvinit Decision, *supra* note 16.
37. See MOFCOM Novartis/Alcon Decision, *supra* note 14.
38. See MOFCOM Uralkali/Silvinit Decision, *supra* note 16.
39. See MOFCOM GM/Delphi Decision, *supra* note 10.
40. *Id.*
41. See MOFCOM Panasonic/Sanyo Decision, *supra* note 12.
42. See MOFCOM Pfizer/Wyeth Decision, *supra* note 11.
43. See MOFCOM Panasonic/Sanyo Decision, *supra* note 12.
44. See MOFCOM Novartis/Alcon Decision, *supra* note 14.
45. See MOFCOM Alpha V/Savio Decision, *supra* note 17.
46. See MOFCOM Uralkali/Silvinit Decision, *supra* note 16.
47. See MOFCOM GE/Shenhua Decision, *supra* note 19.
48. See Art. 7 of the Interim Rules, *supra* note 8.
49. See MOFCOM Panasonic/Sanyo Decision, *supra* note 12.

4.2 Non-Horizontal Mergers

For non-horizontal merger reviews, two issues are particularly important. One is the higher standard of proof required in comparison with horizontal merger reviews. The other is consistency between review of non-horizontal mergers and investigation and prosecution of abuse of dominance conduct. Compared with other jurisdictions such as the US and the EU, it seems that MOFCOM has been more concerned with competition harms of non-horizontal mergers. Indeed, the only case that has been blocked so far, *i.e.* the Coca-Cola/Huiyuan[50] merger, involved portfolio effects in conglomerate merger. And in several vertical merger cases with conditional approval, MOFCOM has focused on foreclosure effects.

Even though there are not many details in the Interim Rules, MOFCOM has mainly followed the way the European Commission deals with non-horizontal mergers. In reviewing vertical mergers, MOFCOM often considers foreclosure effect as the major competition harm. This effect may emerge in upstream or downstream industries depending on market power of the relevant merging parties in the production chain. Again, the key point is that the foreclosure effect must be created by vertical mergers themselves.

In the GM/Delphi[51] merger, for example, MOFCOM found that Delphi was the exclusive auto parts supplier to many domestic Chinese automakers, which were competitors of GM. This exclusive supply relationship and the competition between GM and its competitors in the downstream market made MOFCOM concerned that the proposed transaction might have anti-competitive impacts on the stability of supply, prices and quality of auto parts that used to be produced by Delphi and sold to other domestic automakers. The proposed transaction might thus eliminate competition in the downstream automobile industry by foreclosing other domestic automakers. In particular, MOFCOM was also worried about the hold-up problem between Delphi and other domestic automakers and wanted to ensure that Delphi would not increase switch cost for downstream automakers when they considered switching to other auto parts producers. In the GE/Shenhua[52] case, MOFCOM was concerned about the fact that Shenhua is the major supplier of the specific raw coal that the Coal-Water Slurry (CWS) gasification technology relies upon. Thus the proposed transaction, if not reined in, might eliminate competition in the market for the CWS gasification technology by foreclosing other competitors that own the technology.

On the basis of the information released, there might be two problems with these arguments. One is that MOFCOM failed to prove that the merging parties would have the ability to foreclose competitors downstream. In the GM/Delphi case, for example, at least on the basis of economic theory and international practice, Delphi should have significant market power in the auto parts market. But MOFCOM only mentioned that Delphi was a leader in global and Chinese auto parts markets, providing no further analysis or information of market share or concentration ratio of the auto parts market. Meanwhile, in the GE/Shenhua[53] case, MOFCOM only mentioned that Shenhua was the major supplier of the specific raw coal. However, it did not provide any information on whether Shenhua was dominant in the upstream market, thereby giving the JV the ability to foreclose its competitors in the downstream market.

The other problem is that MOFCOM failed to show whether post-merger, the merging parties would have incentives to foreclose competitors. In the GM/Delphi[54] case or the GE/Shenhua[55] case, for example, if the merging parties legitimately had market power in the upstream market and would therefore earn super industrial profit, why did it have the incentive to exclude competitors in the downstream market? It reminds us of the Chicago critique of the single monopoly profit theory. In other words, more evidence should be needed to prove that such a vertical merger could indeed create profit in some other markets or could help protect rents in the auto parts or the CWS gasification technology market. Meanwhile, GM might also increase procurement of auto parts from Delphi, which would potentially make it more difficult for other domestic auto parts makers to enter GM's procurement system. The merging parties might put other auto parts makers in an inferior position in the upstream auto parts market by foreclosing Delphi's existing and potential competitors. Obviously, MOFCOM was also concerned about GM's market power in the downstream auto market. To prove foreclosure theory in this case, a higher standard of proof is needed, which means that MOFCOM should prove that GM not only had market power in the downstream market and thus had the ability to exclude competition, but that it also had incentives to do so.

5. Patterns and Implications

With more provision rules and regulations being issued and more merger cases being reviewed, MOFCOM is building its capacity to deal with cases more efficiently and effectively. The released cases decisions and the filing process we have participated in, either as independent economist for MOFCOM or as economist for filing firms to prepare competition analysis reports, seem to suggest that some enforcement patterns are emerging that provide important implications for understanding MOFCOM's enforcement policy in the future.

50. See MOFCOM Coca-Cola/Huiyuan Decision, Notice No. 22 [2009], 18 March 2009, available at: <http://fldj.mofcom.gov.cn/aarticle/ztxx/200903/20090306108494.html>.
51. See MOFCOM GM/Delphi Decision, *supra* note 10.
52. See MOFCOM GE/Shenhua Decision, *supra* note 19.
53. *Id*.
54. See MOFCOM GM/Delphi Decision, *supra* note 10.
55. See MOFCOM GE/Shenhua Decision, *supra* note 19.

5.1 Reliance on Market Share to Assess Market Power

Until this stage, MOFCOM has assigned more weight to market share in assessing market power. Indeed, in most cases, if not all, market share and, to a lesser extent, concentration ratios are required information to be submitted to MOFCOM. MOFCOM will then mostly use the market share or concentration ratio to determine whether the merging parties possess market power in the market concerned.

Since there is no regulation on how and what MOFCOM should request from the filing party, MOFCOM can essentially demand any information at any time it deems necessary. For example, if the relevant market defined by MOFCOM is different from what was claimed by the filing parties, MOFCOM may also request market share information of certain product or geographic markets that they are interested in. Right now, the issue of source of evidence has not yet been raised. Indeed, information from third parties is generally accepted even though information from official sources is prioritized.[56]

5.2 More Concerns about Non-Horizontal Mergers

In the assessment of competition effects in horizontal mergers, the Chinese experience is more or less consistent with international practice in the sense that MOFCOM has focused on unilateral effects and coordinate effects.

In non-horizontal merger reviews, however, it seems that MOFCOM has been more concerned with non-horizontal competition effects than other jurisdictions, such as the United States and the European Union. One reason may be that MOFCOM has taken less consideration of the higher standard of proof for such claims of competition harm. Another possibility is that it may have something to do with the unique organizational structure of enforcement agencies. Indeed, unlike the jurisdictions where merger and non-merger cases are investigated in an integrated way, in China, decentralization of enforcement power might create some coordination problems owing to externalities that merger and non-merger enforcement agencies exert on each other.

5.3 Use of Trustee to Monitor the Remedies

In the recently released case decisions, MOFCOM has issued both structural and behavioural remedies. Owing to its capacity limit and increasing numbers of merger filings, it is difficult for MOFCOM to supervise the implementation of remedies. Often, MOFCOM would allow the use of trustees to monitor the implementation process. In the Novartis/Alcon[57] case, for example, MOFCOM ordered Novartis to appoint a monitoring trustee to supervise the implementation of remedies according to the newly issued divestiture guidelines.[58] In the Uralkali/Silvinit[59] decision, MOFCOM allowed the merged party to appoint a monitoring trustee to report to MOFCOM on the implementation of the behavioural remedies to ensure compliance.

5.4 Difference from the US and EU Approaches

In the review process and released decisions, MOFCOM has chosen its own approach to implement the rules and provisions of merger control, although the principles of the rules and provisions possess great similarity to those of the US and the EU. Two good examples are the GM/Delphi case and the Seagate/Samsung case, which are vertical and horizontal mergers respectively. Both mergers were cleared in the US and the EU without any conditions. MOFCOM, however, imposed remedies on both mergers with competition concerns. In the Seagate/Samsung case,[60] in particular, MOFCOM imposed a very rare type of remedy requiring Seagate to operate Samsung's hard disk drive business as a separate business and as an independent competitor for at least 1 year, as this would postpone closure of the deal and increase the transaction cost for the merging parties.[61]

6. Conclusion

China's merger control policy has combined the principles underlying US and EU merger controls while forging its own way forward. Compared with other jurisdictions, it has grown dramatically within a period of just three years. Although it has received some criticism from scholars and practitioners, and has much room for improvement, MOFCOM has been on the right track in building an independent and transparent merger review system. Even though China is not yet a member of the International Competition Network (ICN), it will be open to international antitrust enforcement cooperation and becoming an active member of the global competition community.

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56. Interestingly, there appeared some incoherence here. In the *Renren v. Baidu* case, which was a case under the People's Court, the plaintiff submitted two pieces of market share information, one appearing on Baidu's website and the other on the *Securities Daily*, a national newspaper. But the court dismissed such information, which would likely be accepted by the MOFCOM.
57. See MOFCOM Novartis/Alcon Decision, *supra* note 14.
58. *See* Press Release, MOFCOM, Provisions on Divestiture of Assets or Businesses to Implement Concentrations of Undertakings ("Divestiture Guidelines") (5 July 2010), available at: <http://fldj.mofcom.gov.cn/aarticle/zcfb/201007/20100707012000.html>.
59. See MOFCOM Uralkali/Silvinit Decision, *supra* note 16.
60. See MOFCOM Seagate/Samsung Decision, *supra* note 20.
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Climate Change

A Major Challenge and a Serious Threat to Enterprises

Elbert R. de Jong & Jaap Spier*

1. Introduction

Society at large is confronted with global challenges that can cause economic losses and human tragedies to an extent so far unheard of. In this article, we will focus primarily on climate change.
According to the editorial board of this Quarterly,

> the vast majority of companies, where the major contribution towards a more sustainable future still has to be made, does not move at all. (…) Even within the front running companies the embedding of CSR[1] in existing corporate structures proves to be extremely vulnerable as well and does show high levels of fall-out.[2]

This reluctance towards CSR is clearly illustrated by the present state of affairs in the realm of climate change. This article aims to submit suggestions to overcome the deadlock position. It deals with the legal issues for enterprises that come along with climate change. Similar issues play a role in relation to, *e.g.*, climate change-related risks, such as geo-engineering.
A central feature of climate change is that, if we stick to business as usual, the consequences are largely irreversible.[3] The positive side is that we can still take measures in order to keep the otherwise grievous harm within financially bearable limits.
As a matter of fact, most governments are rather reluctant, or for political reasons not in a position, to agree on the bitterly needed steps to cut Greenhouse Gas (GHG) emissions significantly. So far, the focus has been arguably too much on the role of national states. After all, governments are not the only bodies with responsibilities in this field. Enterprises could also play a very important role within the realm of climate change for two reasons: first, to curb their own GHG emissions and, if possible, to attain significant reductions in industry at large; and secondly, and arguably even more importantly, by urging (their) governments to take a much more active stance, also in the international arena.
We realize that this is easier said than done. After all, the state of the law is still somewhat unclear as to the exact obligations of enterprises. To put it differently: so far, they do not and cannot know with sufficient precision what kind of measures they are legally bound to take. The *nature* of these measures varies *inter alia* according to the kind of activities of the enterprise. For most enterprises, the focus will be on reduction measures. For others, the emphasis should be on more indirect means such as "sustainable" investments.

2. The Road Ahead

We begin by providing a general overview of the threats of climate change for mankind and the threats and opportunities of climate change for enterprises. These are discussed in Section 3. A threat to enterprises lies in the field of liability law. Liability claims might become more relevant than one would think nowadays. Section 4 discusses some bases for the legal obligations regarding the prevention of the materialization of climate change risks. First, a basis could be found in human rights and the so-called Ruggie principles. Second, tort law could serve as a basis for the obligations. Some legal problems concerning wrongfulness come along with the application of tort law. Although liability claims for damages are becoming more relevant, one could doubt whether it is desirable to award such claims. Section 5 elaborates on potential defences that could be invoked by enterprises once they are faced with liability claims. The defences discussed in what follows are based on two aspects of causation and ad hoc mitigation of damages. Next to the enterprises' liability, there is a possibility of holding senior officers personally liable. Section 6 addresses this potential senior officer liability.
Under the current state of the law there still exists uncertainty as to the question of what the precise legal obligation of enterprises are. Section 7 focuses on the implications of this legal uncertainty and discusses various ways in which enterprises could deal with this legal uncertainty. It is argued that an active stance, in cooper-

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1. Corporate social responsibility.
2. Frequently Asked Questions, <www.dovenschmidt.com/faq>.
3. We realize, of course, that climate change and, *e.g.*, geo-engineering are different, in that the former entails huge risks, according to the prevailing view, whereas this is still uncertain, or even unknown altogether, as to the latter.

ation with civil society and potential victims, is in the best interests of enterprises. With such an attitude, they could avoid or reduce threats and costs of liability claims once the risks of climate change have materialized.

Besides, given the legal and natural threats of climate change, a shift of paradigm is needed. Corporations cannot ignore the emerging focus on sustainability. Section 8 discusses the role that enterprises, shareholders, investors and supervisors could play in order to establish such a new paradigm. Before drawing our conclusions, in Section 9 some comments will be made on the difficulties in providing financial safety nets.

3. The Threats of Climate Change

3.1 The Threats to Mankind

"Greenhouse gases" are rapidly increasing in volume in the Earth's atmosphere, mainly because of the human consumption of fossil fuels. The cumulative effect of these gases is to increase average temperatures. This, in turn, will – soon – lead to the increased melting of snow and ice, widespread diseases such as malaria, rising sea levels, dramatic changes in precipitation and wind activity and, in the upshot, as is expected, enormous and largely detrimental changes to the amount of land that is suitable for agriculture and habitation.

Though the world's population at large will suffer serious consequences, the worst and most immediate problems are faced by the poorer parts of the world's population, in overpopulated areas along low-lying coastal regions. Many predominantly Asian and African countries (*i.e.* two billion people or so) are going to face a shortage of water or severe droughts or both.[4] The consequences that we are facing are of an unprecedented magnitude.

3.2 The Threats and Opportunities for Enterprises

Once the threats of climate change materialize, they will undoubtedly be translated into liability issues. This is already a trend, as is illustrated by the increasing litigation in the field of climate change,[5] in academic writing[6] and in the eagerness of a growing number of attorneys to exploit this new legal goldmine.

Much can still be done to prevent the materialization of the threats and, by the same token, the legal threats, particularly in regard to future emissions. Issues concerning liability for emissions in the past are somewhat more problematic. Experience from the past shows that activities that were once widely accepted may be labelled unlawful and sanctioned with liability when the activities turn out to be harmful and extensive losses *have* occurred. Asbestos may serve as an example. This underscores that a (pro) active stance is in the best interests of enterprises.

4. Bases for Legal Obligations

4.1 Human Rights

Academics increasingly argue that climate change is a human rights issue. In this respect, the right to life, health, food and culture come into play;[7] the right to water (which is important as droughts become more frequent or glaciers melt) is becoming a customary norm.[8]

In her annual report of 15 January 2005, the UN High Commissioner for Human Rights addressed the relationship between climate change and human rights:[9]

> the United Nations human rights treaties bodies all recognize the intrinsic link between the environment and the realization of a range of human rights, such as the right to life, to health, to food, to water, and to housing.[10]

She specifically mentions the impact of climate change on these and other rights (such as the right to life).[11] In his view there exists "broad agreement that climate change has generally negative effects on the realization of human rights". She subsequently deals with the question of whether this implies that "such effects can be qualified as human rights violations in a strict legal sense".

In a resolution of 26 March 2008 the UN Human Rights Council emphasized that

> climate change poses an immediate and far-reaching threat to people and communities around the world (…) [which] has implications for the full enjoyment of human rights.[12]

The Ruggie Principles (Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework) impose an obligation on enterprises to act in accordance with human rights. These Principles were endorsed by the UN Human Rights Council on 16 June 2011. Next to this, 44 governments adopted the OECD Guidelines for Multinational Enterprises on 25 May 2011. These

4. The consequences are unevenly divided. Some countries may, after all, benefit from climate change, if we would be indifferent to the adverse impact on part of their society.
5. See, *inter alia,* <www.law.columbia.edu/centers/climatechange/resources>.
6. We confine ourselves to the most important grounds. See for further elaboration: Spier 2012. See on this issue *inter alia*: Abate 2007, pp. 3-76; Faure & Nollkaemper 2007, pp. 123-179; Verheyen 2005; Culley 2002-2003, pp. 91; Grossman 2003, p. 1; Kravchenko 2008, p. 514; Long 2008, p. 177; Hsu <http://works.bepress.com/shi_ling_hsu/6>; Farber 2008, p. 377.
7. See also, for further references, the passionate contribution by Kravchenko 2010, pp. 44-65.
8. *Id.*, pp. 48-49.
9. United Nations, General Assembly, A/HRC/10/61.
10. P. 7 *supra* 18. See in more detail p. 22 nos 65 *et seq*.
11. P. 8 *et seq*.
12. Quoted by Kravchenko 2008, at p. 525. See also ILA report of the 74th conference 2010, pp. 394-395.

Guidelines contain the obligation to comply with internationally respected human rights. Although the legal status of these instruments is somewhat unclear, they foster the idea that enterprises have human rights *obligations*. If one accepts that climate change is a human rights issue, which is quite likely, it follows that companies have *legal* obligations to take certain measures. Human rights may serve as a legal basis for litigation if they refrain from taking the legally required steps. As already mentioned, there is still legal uncertainty as to the question of what exactly has to be done by enterprises; see Section 7 for an elaboration.

It should be noted that the Ruggie Principles stretch well beyond the enterprises' own activities. They speak of a requirement to avoid causing or contributing to adverse human rights impacts "through their own activities" and the obligation to "seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations, products or services by their business relationships, even if they have not contributed to those impacts".[13]

4.2 National Tort Law (Wrongfulness)

Tort law could also serve as a basis for shaping the legal obligations of enterprises.

The first question that tort law has to address is the following: what is, in the given circumstances, proper conduct?[14] The European Principles on Tort Law elaborate on this topic as follows: the required conduct depends

> in particular, on the nature and the value of the protected interest involved, the dangerousness of the activity, the expertise to be expected of a person carrying it on, the foreseeability of the damage, the relationship between those involved, as well as the costs of precautionary or alternative methods.[15]

A similar approach is adopted in, for instance, the US,[16] Australia[17] and South Africa.[18]

4.2.1 Foreseeability, Proximity and Costs

Most, but not all, of the just mentioned criteria point in the direction of far-reaching obligations. With respect to climate change, particularly the interpretation of foreseeability, proximity and the costs issue play an important role. In view of the (decreasing) uncertainty about climate change risks, and the long tail of these risks, an important issue is whether or not the risks were sufficiently known or understood at the time of the emissions. In this respect, the International Commission of Jurists persuasively submits the view that in considering what a prudent company would have foreseen, the court will look at "objective evidence as to what kind of information was available to the company about the risk (…) from its own employees and consultants, the media and civil society". The decisive point is whether "a reasonable person in the company's shoes would have undertaken an inquiry as to the potential risks involved".[19]

As to proximity, it is at least open to debate whether there is a sufficient relationship (proximity) between, say, a German enterprise and the people of Bangladesh. Arguably even not between "the German people" and a German enterprise based on one single or perhaps a very few German locations.

Next to proximity, enterprises could harp on about the issue of the expenses to be incurred in order to reduce GHG emissions, arguing that doing this would amount to a very heavy burden. We tend to believe that the importance of this factor should not be overstretched. Given the magnitude and seriousness of the threats of climate change, the possibility that they will materialize if we stick to business as usual and the evil done in case of materialization, a certain financial backdrop is unlikely to be accepted as an "excuse" for refraining from taking the necessary steps.

5. Potential Defences: Two Issues of Causation and Ad Hoc Mitigation

Establishing liability for the losses brought about by climate change is fraught with difficulties. We address the two potentially most serious legal obstacles: two aspects of causation (the *condicio sine qua non* requirement and the attribution of damage) and ad hoc mitigation of damages. Next to these legal issues, the question arises whether *ex post* liability for damages caused by climate change is desirable.[20]

The effect of wrongful individual emissions by (almost) all states, and even more so by (almost) all major enterprises, is marginal.[21] This begs the question whether minimal causation (a contribution per enterprise of far below 1% of the global losses in the overwhelming majority of cases)[22] suffices for liability.[23] Opinions on this point are divided.[24] By way of example, the Commentary on Article 3:106 Principles of European Tort Law (PETL) may serve as a basis for an argument

13. See Principle 13.
14. See Van Dam 2006, pp. 189 *et seq*.
15. Art. 4:102 para. 1.
16. Dobbs 2000, Section 145.
17. Trindade & Cane 1999, p. 341 *et seq*.
18. Neethling, Potgieter & Visser, *Deliktereg* (6th ed.), pp. 36 *et seq*.
19. *Corporate Complicity & Legal Accountability, Volume 3 Civil Remedies*, International Commission of Jurists, Geneva 2008, pp. 17 and 18.
20. We do not address the so-called political argument, which originated in the US. This will be done in forthcoming publications. In short, the argument is particularly relevant if the legislator has not enacted rules on the obligations of enterprises. In such a scenario one could argue that it is a political issue to decide the extent of the required GHG reductions. In our submission, in such a scenario the *courts have to* interpret the law as it stands.
21. See for more details about the various ways of measuring wrongful emissions Spier, in Tichy 2007, pp. 69 *et seq*.
22. That is, the contribution of a single enterprise in relation to a specific loss is marginal.
23. The predominant view is that this is a causation and not a wrongfulness issue.
24. See for more details Winiger, Koziol, Koch & Zimmermann 2007, pp. 531 *et seq*.

against compensation.[25] The minimal causation defence can be invoked anyway by small emitters, such as private persons and small enterprises. It is open to debate whether the same holds true for major (multinational) enterprises and/or national states. A recent case (*Sienkiewicz v. Greif*[26]) decided by the Supreme Court of the UK may serve as an illustration of an answer in the affirmative. The victim had been exposed to asbestos. The defendant's exposure increased the asbestos exposure in the atmosphere by 18%. The defendant was held liable for the percentage of the increase. That would not be overly spectacular, were it not for the fact that the judgment is based on the assumption that the victim's "exposure to asbestos over her working life at Greif's factory increased the risk to which environmental exposure subjected her from 24 cases per million to 28.39 cases per million".[27] That is, the chance that a loss could be attributed to Greif is very, very marginal. If we would apply a similar reasoning in the field of climate change, the causation defence of most defendants may vanish into thin air.

Assuming that this defence could be successfully invoked in relation to claims for damages, this does not necessarily jeopardize *injunctive relief*. If the defence would also be an insurmountable hurdle for injunctive relief, the law could not come into play in relation to a "marginal" contribution to fatal damage to society at large. This would imply that the law could not serve as a vehicle to prevent the colossal losses that will occur if we do not change course. Such a position would be rather unbalanced if we bear in mind that courts often go out of their way to accommodate victims in quite a few – sometimes even trivial – cases.

Once the *condicio sine qua non* test is met, enterprises will face the question *to what extent* the losses caused by them have to be compensated. Once again, the Principles of European Tort Law may serve to illustrate how to deal with this question. Article 3:201 PETL concerns the "scope of liability". Whether and to what extent damage may be attributed to a liable person depends on a series of factors, such as the protective purpose of the violated rule and the foreseeability of the loss(es). In this context the proximity in time or space between the damaging activity and its consequences plays a role once again. If there would be room for damages at all, a restriction in time and space would be desirable. For example, a French medium-sized enterprise should not be required to compensate victims in, say, Mexico.

In several legal systems, such as Denmark, Finland, the Netherlands, Norway, Poland, Portugal, Spain and Sweden,[28] damages may be reduced in exceptional cases if, in the light of the financial situation of the parties, full compensation would be an oppressive burden. In that respect, factors such as the magnitude of the damage play a role. Once again, this vehicle could play a useful role in keeping liability within bearable limits, if liability for damages would be a starter.

5.1 Desirability of Damages

Besides the legal obstacles to liability, one could cast doubt on whether liability for damages is *desirable*, which is a matter of legal policy. In our submission, full-fledged liability for damages would be an oppressive burden for enterprises (and insurance companies). This may not necessarily be so in the short term, but in the longer term the aggregate losses will be so colossal that no company would be able to pay even its proportional share.[29] This could be avoided by liability caps, but these caps require a legal basis.[30] That is, legislative action on a *global* scale, which is not an overly realistic scenario.[31]

6. Liability of Senior Officers?

In an Addendum to his earlier mentioned report, Prof. Ruggie points to a clear trend towards a general requirement for directors to act in the company's best interests. According to the US report, this duty includes an oversight of risk management and a periodic review to prevent and detect any violation of the law, including human rights abuses.[32] If one accepts the view that climate change is also a human rights issue, then senior officers are required to urge the enterprise to take the necessary steps. As will be discussed in Section 7 below, the problem is that it is unclear what is meant by "necessary" steps. Therefore, in our view, senior officers can only be held personally liable in rather extreme scenarios, *i.e.* if it is beyond reasonable doubt that the corporation did not meet the legal standards and that the senior officer negligently failed to do his very utmost, within the scope of his responsibilities, to urge the enterprise to reduce its GHG emissions or, as the case may be, to take other appropriate actions.

Obviously, the personal liability of senior officers will be of little avail to victims, since the amount of losses will be much higher than the officers' assets. Yet, the threat of personal liability may be an appropriate vehicle to bring about the apparently needed change of mindset, as is illustrated by the quotation at the very beginning. As a matter of fact, this threat does not (yet) seem very effective, arguably, so far, because it is less credible. Hence other and more effective means should be explored. A sincere and conscientious application of CSR could play a very important role in attaining the goal of a more responsible and responsive position towards climate change. Yet, one should not overesti-

25. European Group on Tort Law, Principles of European Tort Law, Text and Commentary Art. 3:106 (Spier), pp. 58 and 59.
26. *Sienkiewicz v. Greif* (UK) Ltd., [2011] UKSC 10.
27. See per Lord Phillips *supra* 60.
28. *Text and Commentary Art. 10:401* (Moréteau), pp. 179 and 180.
29. See, *e.g.*, the earlier mentioned Stern Report.
30. One could draw inspiration from caps on liability for nuclear plants and in the field of transport, maritime and environmental law; see Sands 2013, pp. 904 *et seq*.
31. Caps by national states will bring some solace, of course, but they leave untouched potential full liability in other countries (where the enterprises may have subsidiaries and/or assets).
32. UN, General Assembly, A/HRC/17/31/Add2 of 23 May 2011, p. 15.

mate the importance of CSR, given that the boundaries and the concrete requirements are still not very clear.

7. How to Make the Legal Obligations Clear and Concrete

One of the core issues is that it is still unclear *how much* enterprises must cut their GHG emissions. In what follows, we will address various possible ways (for enterprises) to fill in these obligations, although some problems do emerge when taking these routes.

In a sense, global[33] *international* agreements would be the best way to attain this goal. *Realistically speaking*, this might probably be the worst solution for mankind. The interests of the countries around the globe diverge to such an extent that it seems almost impossible to get at the level of reductions needed to avoid passing the tipping point of an increase in global temperature by more than 2ºC. The outcome of the international negotiations since Kyoto is telling. Besides, the political support for the necessary reductions in vital countries, such as the US, is so limited that only small steps can be taken. Next to this, a global international agreement will likely contain abstract norms that need to be interpreted in order to make the enterprises' obligations sufficiently concrete. Thus, we would be going back to square one.

Theoretically, *national* legislators could fill the gap by enacting very specific and detailed legislation. This is fraught with difficulties, too. National legislators are to a certain extent bound by the rules of international law and human rights. National legislation may go *beyond* the requirements of the latter, but cannot impose a lower level of protection than international law requires. Given that these requirements are unclear, it is impossible to determine whether national provisions would or would not be more lenient for enterprises than international ones. Moreover, many enterprises have subsidiaries in other countries and/or are engaged in activities all over the globe. In turn, they face a wide range of applicable standards. If each national state would enact its own legislation, enterprises run the risk of being confronted with a series of varying standards that will make doing business rather complicated. An enterprise could solve this issue by complying with the rules with the highest level of protection for present and future generations. This would, we think, be in line with the spirit of CSR.

It is in the best interests of enterprises – and the world at large – to clarify what the obligations of enterprises are. In the meantime they cannot lean backwards. Given the magnitude of the climate change risks that are going to materialize if we allow things to happen, enterprises have an obligation to curb GHG emissions. Although the precise extent of the legally required reduction is unclear, it is quite obvious that enterprises cannot refrain from taking any action at all. Even without a proper understanding of the law, the very least they must do is to cut unnecessary emissions that can be avoided at low costs.

In order to get to the clarification of how much GHG emissions should be reduced, enterprises would be best advised to join forces with civil society and/or the most obvious classes of victims. In the spirit of social responsible behaviour, they could *jointly* seek declaratory relief, *i.e.* to ask the court to rule what the enterprises' obligations are. Moreover, by asking the court to formulate their obligations, they can also avoid liabilities, assuming that they will comply with the court's ruling. For example, if in 2011 a court orders a company to reduce its GHG emissions by 10% and law progresses over time, say by 2021, in such a way that the company had to reduce its emissions by 20% in 2011,[34] one could hardly imagine liability for damages for the difference of 10%. A different solution would clearly be contrary to legal certainty and the rule of law. After all, the corporation did comply with the court's order.

Consider a variation on this example: in 2011 a national court held that an enterprise had to reduce its GHG emissions by 10%, while a few years later it turns out that according to international or human rights law the court was mistaken. In such a scenario it is very unlikely that a company that complied with the ruling of a national court can be held liable in that country, unless it was quite obvious that the national court was mistaken.

Nonetheless, legal norms are dynamic. They change over time. It follows that once a norm has *clearly* changed, enterprises have to meet the new requirements. In that respect a declaratory judgment does not relieve enterprises from having to keep pace with the new insights. This submission is in line with the "race to the top" observed by UN Global Compact.[35]

8. A Shift of Paradigm

So far, it has proven extremely difficult to come to grips with climate change. Besides the legal problems, dealing with climate change also urges enterprises to focus on their corporate *social responsibility* in relation to the vulnerability of the "environment" in which they do business. Corporations cannot ignore the winds of change, *i.e.* the emerging focus on sustainability. A shift of corporate paradigm from a sole focus on the short-term goals and benefits for the enterprise to a focus on the place and influence of the enterprise's activities on society at large becomes desirable, if not imperative. In this

33. Regional agreements – *e.g.* in the EU context – would certainly be helpful, but they cannot solve the whole problem. After all, most multinational enterprises are engaged in world-wide activities which are not solely governed by regional rules.

34. That is, the law progresses over time with retroactive effect.

35. UN Global Compact, *Blueprint for Corporate Sustainability Leadership*, United Nations, 2010, p. 1.

respect the following issues come into play. First, as has already been discussed above, it is not unlikely that sticking to business as usual will lead to claims for damages.[36] Second, besides the issue of liability for damages, business as usual will end up in a financial catastrophe for the world and, by the same token, for the industry. The Stern Report[37] is telling, in this respect, concerning the financial doom that will emerge if we refrain from a significant cut in GHG emissions.

We realize, of course, that a unilateral change of course by one or a few enterprises is not an easy choice. After all, enterprises that embark on far-reaching reductions of GHG emissions, whilst their competitors stick to business as usual, may face a competitive backdrop.[38] In the longer term this backdrop may be rewarding if the competitors are driven out of business due to a series of claims, but few enterprises have such a long horizon. However, speculating on the long-term benefits is a risky exercise for two reasons. First, it is open to debate whether this liability risk for competitors that *abstain* from taking action will materialize. Second, and more importantly, the responsible corporations may be faced with a huge impact on their business and short-term profitability owing to the competitive disadvantage. This illustrates the tension between the old and the new paradigms. Below, we will focus on ways to get at the new paradigm without facing the aforementioned risks.

Shareholders and investors could play an important role. They should – and often have – a longer-term perspective. Many of them are pension funds or insurers. Their fiduciary duties urge them to focus on the longer term. If the worst comes to the worst, which is unavoidable if we do not change course, their assets will be greatly affected. Therefore, shareholders and investors have a clear interest in encouraging and, if need be, urging enterprises to abstain from pursuing short-term goals that would obviously have an adverse impact on their long-term ability to generate profits.[39]

The same largely holds true for the supervisors of pension funds, banks and insurers (major investors). They are in a perfect position and have to ensure that those under their supervision take their fiduciary responsibilities seriously. Supervisors could – and should – urge those under their supervision to refrain from investing in "unsustainable enterprises".[40]

Since national governments have proven to be rather ineffective in coping with climate change, strong and irresistible pressure is needed.[41] Supervisors (often independent national banks) and major investors are in a position to influence politicians and the decision-making process. More likely than not, pressure from these institutions will often be welcomed by politicians. It enables them to justify unpopular measures to the public (their voters). *Ideally speaking*, this could create a global level playing field. Reality will probably prove otherwise as it is far-fetched to assume that this kind of "pressure" will work around the globe. Even if a global level playing field may not be established in the near future, national and regional level playing fields are possible and useful.

9. Financial Safety Nets

Quite a few academics advocate financial solutions, such as insurance cover, to cope with the deleterious consequences of climate change. These consequences could be either liability for damages ("covered" by liability insurance) or personal injury and damage to property ("covered" by first party insurance).

As to liability insurance, it is in the laps of the gods whether liability risks will materialize; see above. But even if this would not be the case, enterprises have to reckon with massive and very expensive litigation. A Ceres' report of 2010 about the climate change perception reveals that over the past decade the insurance industry has become increasingly concerned about climate change risks to its corporate customers and about liability exposures stemming from damages associated with historical greenhouse emissions.[42] According to this report 22.4% of respondents in the industrial sector considered legal risks in this realm in the next ten years to be "very likely".[43]

The Royal Gazette (of Bermuda) may well be right in saying that climate change is "an underwriter's worst nightmare".[44] *The New York Times* has a point in observing that climate change claims echo "those in suits against the tobacco industry".[45] A parallel with the asbestos litigation is arguably even more striking. *The New York Times* quotes Michael Gerrard, an eminent expert and law professor at Columbia:

> They [the plaintiffs] lost the first [tobacco] cases; they kept trying new theories and they eventually won big.

In the short term, insuring against climate change related risks may, or may not, be an option: in the longer term insurers will face irresponsibly high risks in pro-

36. As discussed in Sections 4.2 and 5, it is not unlikely that these claims will be dismissed. Even in that case, litigation will generate substantial defence costs.
37. The economics of climate change.
38. Such a backdrop could be mitigated by competition law or international trade law.
39. See, *inter alia*, "Global Investor Statement on Climate Change: Reducing Risks, Seizing Opportunities & Closing the Climate Change Gap", November 2010.
40. In the short term, this may be a mirage. It is not unlikely that the number of truly "sustainable" corporations is insufficient for the enormous amounts to be invested.
41. The amount of pressure depends on the steps already taken.
42. *Climate Change Risk Perception and Management: A Survey of Risk Managers* 2010, p. 1. See also Munich Re, *13th International Liability Forum, Climate Change Litigation and Environmental Liability* 2009.
43. O.c., pp. 9 and 10.
44. 27 September 2010. *The Gazette* reports on a session of the International Reinsurance Summit.
45. 27 January 2010, "Courts as Battlefields in Climate Fights", <www.nytimes.com/2010/01/27/business/energy-environment/27/lawsuits.html?_r>.

viding this kind of coverage.[46] Early in 2011 Munich Re (one of the leading re-insurers) launched a press release stating that the total amount of climate change damage in 2010 is estimated at US$130 billion, of which US$37 billion was covered by insurance.[47] As to liability insurance, given the present state of climate change science, it may be difficult to prove a causal link between a specific loss and man-induced climate change. With respect to liability and first party insurance, for the time being, it seems difficult to assess the magnitude of the potential exposure. No doubt, this will change over time, leaving aside whether an insurer issuing just quoted messages could reasonably deny such a link. More importantly, the weather patterns seemingly change so rapidly – in line with IPCC predictions – that we may take it for granted that future losses may skyrocket.

A way to solve the just mentioned problem is to put a cap on the *overall* exposure of insurers in relation to either the amounts to be paid per year or per event. An example of such a cap can be found in the case of insurance for losses caused by acts of terrorism (*e.g.* in the Netherlands €1 billion per year or €75 million per insured location; in Belgium €1 billion). There are two ways to introduce such a cap: by means of the terms and conditions of the insurance contract or by law. The latter is much safer for insurers as it gives less leeway for courts to interpret (or, for practical purposes, to remove) the cap. In this respect, insurers (should) have learnt their lesson from the hostile reception to loss occurrence and claims-made policies in quite a few courts in various countries.[48]

10. Conclusion

If we do not change course, our future looks grim. Although we realize fairly well that such a position is harsh for victims, damages are not a realistic option. If we cannot come to grips with climate change, the losses will be too colossal.

The same holds true for insurance. It may offer a solution in the short term. In the longer term the risks and the losses are of such a magnitude that they go well beyond the insurable.

A potential solution might be to put caps on liability or on insurance coverage for aggregate losses. Caps may save enterprises, but they are to the detriment of victims. The "first" victims may get compensation. In the somewhat longer term, most will be left empty-handed as the losses will grossly exceed the caps. In that scenario it should at least be clear how to divide the limited means available for victims.

Leaving millions and, as time progresses, billions of people (present and future) uncompensated is not an appealing option. Over the centuries, law has developed to accommodate victims. Most cases are about small-scale evil, if not injustice done to single persons. It cannot be true that the law is only about misery to individuals and cannot bring solace if the future of humanity is at stake.

The gist is that the materialization of climate change *must* be *avoided*. To some extent one can appreciate that enterprises are unaware of their obligations. The best way forward is that they, together with NGOs, civil society and classes of potential victims, seek declaratory relief as soon as is practical. Thus, they could contribute to the seriously needed prevention of unnecessary climate disasters.

A few corporations may feel tempted to lean backwards. They would be mistaken. Although the state of the law is not (yet) overly clear, it would be belabouring the obvious to repeat that enterprises should curb unnecessary GHG emissions that they could easily avoid. If they do not do so, they or their senior officers or both may face the force of the sword of the law, and not necessarily only private law.

46. We do not focus on "innocent" and useful coverage, such as coverage for low carbon power installations. If coverage could be terminated each year and would be very precise, the risks may be manageable, even in the longer term. But if the massive adverse effects are going to materialize, premiums will be so high that few will be able (and willing) to pay them.
47. 3 January 2011.
48. See, *inter alia*, M.A. Clarke, *The Law of Insurance Contracts* Section 17-4A-C and R.H. Jery, II, *Understanding Insurance Law* Sections 62 and 65 b and e.

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