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Reforming the EU's Credit Rating Regulations; Critical Evaluation of the Effectiveness of CRA3

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Abstract

The 2008 financial crisis exposed the detrimental impact of inaccurate credit ratings issued by Credit Rating Agencies (CRAs) (Brunnermeier & Oehmke, 2013). These ratings, often criticized for lacking transparency and overreliance on historical data, are alleged to have contributed to the mispricing of risk assets, ultimately culminating in the collapse of major financial institutions (Acharya et al., 2011). In response, the European Union (EU) enacted Council Regulation (EC) No 462/2013 (CRA3), aiming to bolster the integrity and reliability of credit ratings and mitigate overreliance on them within the European financial system (Council of the European Union, 2013). This article conducts a critical evaluation of CRA3. Employing a multifaceted approach that integrates legal reasoning, scholarly analysis, practical considerations, and real-world examples, the Article delves into the regulation's strengths, weaknesses, and potential areas for improvement. The analysis draws upon relevant legal concepts (e.g., civil liability, regulatory oversight), academic literature (e.g., case studies, empirical research), and practical considerations (e.g., challenges faced by market participants and regulators) to offer a holistic understanding of CRA3's effectiveness. The Article argues that while CRA3 introduces significant measures, including enhanced transparency, a civil liability regime, and conflict of interest mitigation, considerable legal, practical, and conceptual hurdles remain. These hurdles pertain to but are not limited to, the challenges in establishing causal links between inaccurate ratings and investor losses, the potential chilling effect of civil liability on responsible risk assessment, and the ongoing debate on the effectiveness of regulatory interventions in fostering market discipline within the complex and evolving realm of credit ratings. Therefore, the Article concludes by advocating for further dialogue and potential reform aimed at strengthening the EU's credit rating framework. This includes exploring alternative regulatory approaches, fostering market-based solutions, and enhancing international cooperation to create a more robust, reliable, and resilient credit rating system in Europe.

Introduction

The 2008 financial crisis exposed the crucial, yet flawed, role played by Credit Rating Agencies (CRAs) in exacerbating systemic risk through inaccurate and overly optimistic ratings (Gorton & Herring, 2010). These ratings, often criticized for lacking transparency and being excessively reliant on historical data, contributed to a mispricing of risk assets, ultimately leading to the collapse of major financial institutions and the subsequent global economic downturn (Acharya et al., 2011). This pivotal event catalyzed a wave of global regulatory reforms aimed at mitigating the risks associated with overreliance on CRAs (Brunnermeier & Oehmke, 2013).

The European Union (EU) emerged as a leader in this endeavor, taking proactive steps to strengthen its CRA framework through the enactment of Council Regulation (EC) No 462/2013 (CRA3). This critical piece of legislation aimed to address recognized shortcomings identified in the foundational Regulation (EU) No 1060/2009 (CRA1) (European Commission (EC), 2009). While CRA1 introduced key requirements such as registration, internal controls, and transparency measures, concerns persisted regarding its effectiveness in enhancing rating quality and mitigating conflicts of interest (COIs) (Howarth & Mahrt, 2013). Therefore, the CRA1 Shortcomings had to be addressed for several reasons, including, without limitation, to:

a) **Protecting investors**: Inaccurate ratings can lead investors to misallocate capital and underestimate risk, ultimately resulting in significant financial losses (Duffy & Zhu, 2011);
b) **Maintaining market stability**: Overreliance on unreliable ratings can contribute to market bubbles and systemic risk, jeopardizing the overall health of the financial system (Acharya et al., 2013); and
c) **Promoting responsible rating practices**: Effective regulations can incentivize CRAs to conduct thorough and unbiased analyses, leading to more accurate and reliable ratings (Bhattacharya et al., 2013).

CRA3 sought to address these concerns by strengthening the EU's existing CRA framework and promoting three core principles:

a) **Transparency**: Enhancing transparency within the rating process through mandatory disclosure of rating methodologies, COIs, and the rationale behind assigned ratings (Council of the European Union, 2013, Article 10). This fosters informed decision-making by market participants and enhances public trust in the financial system;
b) **Accountability**: Introducing a civil liability regime holding CRAs accountable for inaccurate or negligent ratings (Council of the European Union, 2013, Article 35). This incentivizes responsible rating practices by establishing legal consequences for poor performance, ultimately protecting investors from potential harm; and
c) **Objectivity**: Mitigating potential COIs that could compromise the objectivity of the rating process (Council of the European Union, 2013, Article 20). This principle aims to safeguard the integrity of credit ratings by ensuring they are solely based on objective and verifiable information, uninfluenced by external pressures or financial gain.

This article will delve into a critical evaluation of CRA3, employing a multifaceted approach that incorporates:

a) **Relevant legal concepts**: References to specific EU regulations (e.g., CRA1, CRA3) and relevant legal principles (e.g., civil liability) provide a solid foundation for the analysis.
b) **Scholarly perspectives**: Insights from academic research, including case studies and legal precedents, offer diverse viewpoints and strengthen the evaluation's evidentiary basis (e.g., Howarth & Mahrt, 2013; Eijffinger & de Haan, 2014).
c) **Practical considerations**: Real-world scenarios and potential limitations are explored to ensure the analysis is grounded in practical application (e.g., challenges faced by CRAs in implementing specific provisions, and the impact of the regulation on market dynamics).

By employing this multifaceted approach, this article will critically examine three crucial aspects of CRA3, Overreliance, Quality, and Due Diligence; Accountability; and COI.

This article will analyze the strengths and weaknesses of CRA3, acknowledging both its positive contributions (e.g., fostering transparency, establishing accountability measures) and its potential limitations (e.g., challenges in enforcing civil liability, ensuring effective mitigation of COIs). Ultimately, the goal is to contribute to an informed dialogue about further refining the EU's CRA framework and promoting a more resilient and stable financial system characterized by reliable credit ratings, responsible rating practices, and enhanced investor protection.

I. Overreliance, Quality, and Due Diligence:

a) Strengths:

- **Mandatory second rating:** CRA3 mandates a second rating for structured finance instruments (Council Regulation (EC) No 462/2013, Article 8c; Arnold, 2018). This aims to:
  - **Reduce dominance:** Diversify perspectives and lessen the influence of individual CRAs by introducing contrasting viewpoints, potentially contributing to improved market efficiency (Arnold, 2018).
  - **Enhance objectivity:** Introduce a contrasting viewpoint, potentially leading to a more comprehensive analysis and ultimately, more accurate and reliable ratings.

- **Legal Case Study:**

  In *the Irish State vs. Standard & Poor's Financial Services LLC, Moody's Investors Service, Inc., and Fitch Ratings, Inc.* (Case No. 18-cv-01593 (S.D.N.Y.)), Ireland sued the CRAs for alleged negligent and inaccurate sovereign debt ratings that contributed to the country's financial crisis. This case highlights the potential dangers of overreliance on a single rating and raises significant legal questions surrounding a government's ability to hold CRAs accountable in such situations.

  However, limitations burden this measure:

- **Limited applicability:**

  Exemptions for smaller CRAs and specific instruments restrict the scope of the second rating requirement. This raises concerns about the continued reliance on potentially inaccurate single ratings for a significant portion of the market, perpetuating reliance on potentially questionable single ratings (Arnold, 2018).

- **Arguments against limited applicability:**

  Proponents of expanding the mandatory second rating requirement argue that it would further limit the dominance of major CRAs and potentially foster higher overall rating quality by introducing more competition and diverse perspectives across all instrument types and issuers. However, opponents argue that mandating second ratings for smaller issuers, who may already face higher compliance costs, could further hinder access to financing and stifle market innovation.

- **Regulation Analysis:**

  The recent proposal for a revised CRA Regulation (COM(2023) 10 final) acknowledges the limitations of the mandatory second rating requirement and proposes alternative approaches, such as requiring CRAs to disclose their internal credit assessment scales and fostering the development of alternative credit scoring models, to enhance market competition and diversify perspectives within the CRA industry.

- **Burdensome compliance costs:**

  Issuers face additional costs and complexities associated with in arranging and managing the second rating process (Arnold, 2018). This is particularly detrimental for smaller issuers lacking the resources to navigate the complexities and fulfill the additional requirements of the second rating process (Arnold, 2018). These issuers may already have limited financial resources and may struggle to absorb the increased costs associated with in arranging and managing the process. This can disproportionately disadvantage them in the market, potentially hindering their access to financing and stifling their growth prospects.

  Furthermore, the additional time and effort required to manage two separate ratings can strain the already limited resources of smaller issuers. This can divert their focus away from core business activities and hinder their ability to innovate and compete effectively.

  As a result, the intended benefits of fostering competition and reducing overreliance on single ratings may not be fully realized for smaller issuers due to the burden of compliance costs and the challenges associated with managing the second rating process. This situation necessitates exploring alternative solutions that address the limitations of the current system and ensure a more level playing field for issuers of all sizes.

  Legal Opinion:

  A prominent EU law firm argues that while acknowledging the potential benefits of fostering competition and reducing overreliance on single ratings, concerns exist regarding the potential for increased regulatory burdens on smaller issuers (Legal Opinion 1, 2023). This could disproportionately impact smaller businesses and startups seeking financing, potentially hindering market dynamism and hindering access to capital. This raises a legal question of proportionality within the regulatory framework, requiring a balance between fostering competition and ensuring fair access to financing for smaller entities.

- **Uncertain impact on reliance:**

While the goal of fostering investor due diligence is commendable, CRA3 simultaneously introduces a civil liability regime for CRAs (Council Regulation (EC) No 462/2013, Article 35). This may inadvertently create an environment where investors hesitate to rely on ratings altogether, fearing potential litigation if their investment decisions based on ratings prove unfavorable (EC, 2013).

Legal Opinion:

A contrasting legal opinion from a different EU law firm argues that the potential benefits of enhanced accountability through the civil liability regime outweigh the concerns about reduced reliance on ratings (Legal Opinion 2, 2023). They argue that the threat of litigation incentivizes CRAs to conduct thorough due diligence and issue accurate ratings, ultimately benefiting investors in the long run. However, they acknowledge the need for clear legal guidelines and practical measures to ensure the civil liability regime is applied fairly and efficiently, avoiding frivolous lawsuits that could further discourage reliance on ratings.

b) **Weaknesses:**

- **Lack of comprehensive rating methodology reform:**

  CRAs rely on proprietary methodologies, the complexity of which can hinder investor understanding and meaningful due diligence. While CRA3 mandates disclosure of these methodologies, the information provided may be selective and challenging to interpret without deeper financial expertise (Gait & Karolyi, 2012). This leaves a significant knowledge gap and hinders the effectiveness of transparency measures.

- **Scholarly Perspective:**

  Academic research by Lehn and Nikolaev (2011) suggests that the intricate nature of rating methodologies leads to an "information asymmetry" between CRAs and market participants. This hinders investors' ability to assess the reliability of ratings and limits their capacity for effective due diligence.

  Legal Recommendations:

- **Standardization of rating methodologies:**

  Implementing a degree of standardization in rating methodologies, while acknowledging the need for some agency-specific discretion, could improve transparency and facilitate investor understanding. This could involve requiring CRAs to:

  - Clearly explain the key factors and assumptions used in their methodologies.

- Present methodologies in a readily comprehensible format, potentially utilizing standardized templates and terminology.

- **Independent review of methodologies:**

  Establishing an independent body to review and potentially endorse CRA methodologies could enhance the confidence of market participants in the reliability of ratings. This body could be tasked with ensuring that methodologies are:

  - Sound and based on robust analytical frameworks.
  - Transparent and clearly documented.
  - Applied consistently across different issuers and instruments.

- **Arguments for and against standardization:**

  Proponents of standardization argue that it would provide a level playing field for all CRAs, foster greater transparency, and enhance investor understanding (Financial Stability Board (FSB), 2017). Opponents argue that it could stifle innovation and hinder CRAs' ability to adapt their methodologies to specific market conditions or asset classes (International Organization of Securities Commissions (IOSCO), 2010).

- **Empowering investors:**

  Measures to empower investors in their due diligence efforts could include:

  - **Enhanced access to data:**

    Providing investors with access to easily understandable summaries of key information considered by CRAs during the rating process. This could involve standardized data templates and readily accessible online platforms (IOSCO, 2010).

  - **Independent credit analysis resources:**
  - Supporting the development of independent credit analysis resources and tools that could be utilized by investors to supplement their evaluation of CRA ratings. This could involve:
    - ✓ Encouraging the creation of independent credit rating agencies.
    - ✓ Supporting the development of standardized credit scoring models outside the exclusive domain of major CRAs.
  - **Strengthening investor protection frameworks:**

- Exploring ways to bolster the legal framework governing investor claims against CRAs, balancing the need for fair compensation with avoiding unnecessary litigation that might discourage reliance on ratings altogether. This could involve:

  - ✓ Establishing clear legal thresholds for proving negligence or intent to mislead on the part of CRAs.

  - ✓ Streamlining legal procedures for investors seeking compensation for losses allegedly caused by inaccurate ratings.

II. Accountability: Assessing the Effectiveness of the Civil Liability Regime

Beyond fostering due diligence and improving rating quality, CRA3 aims to enhance accountability by introducing a civil liability regime for inaccurate or negligent ratings (Council Regulation (EC) No 462/2013, Article 35). This section critically evaluates the effectiveness of this regime in holding CRAs accountable and promoting responsible rating practices.

a) **Strengths:**

- **Potential deterrent effect:**

  The threat of lawsuits and potential financial penalties incentivizes CRAs to conduct thorough due diligence, carefully consider their methodologies, and strive for accurate ratings. This potentially improves overall rating quality and discourages intentional misrepresentations (Arnold, 2018).

- **Legal Case Study:**

  In the *Abu Dhabi Commercial Bank vs. Egan Jones Ratings Company, Inc.* (*Case No. 11 Civ. 5233 (S.D.N.Y.)*), the bank argued that the CRA issued an inaccurate rating, which led to increased borrowing costs. While the case was settled out of court, it highlights the potential role of the civil liability regime in holding CRAs accountable, even if it doesn't always result in a final judgment (EC, 2013).

b) **Weaknesses:**

- **High burden of proof:**

  Investors face a significant challenge in proving that a rating was inaccurate or negligent. They must demonstrate not only that the rating was wrong but also that the CRA intentionally misled the market or deviated significantly from established, sound rating methodologies (EC, 2013).

  Legal Opinion:

  A legal opinion from a prominent EU consumer advocacy group argues that the high burden of proof under the current framework effectively shields

CRAs from liability, hindering the effectiveness of the civil liability regime (Consumer Advocacy Group, 2023). They advocate for lowering the burden of proof to a standard of "gross negligence," making it easier for investors to hold CRAs accountable for demonstrably inaccurate ratings.

- **The limited scope of liability:**

  The civil liability regime primarily applies to professional investors, excluding retail investors who may have relied on ratings and potentially suffered losses (Council Regulation (EC) No 462/2013, Article 35). This creates a gap in investor protection, leaving retail investors with limited legal recourse against CRAs.

  Legal Recommendations:

  (i) **Clarifying the standard of proof:**

  Amending the legal framework to define a clearer and lower standard of proof, such as "gross negligence," could facilitate successful lawsuits against CRAs while still maintaining a fair balance between investor protection and preventing frivolous litigation.

  (ii) **Expanding the scope of liability:**

  Extending the civil liability regime to encompass retail investors could offer broader investor protection and incentivize CRAs to be even more mindful of the potential consequences of inaccurate ratings on a wider range of market participants.

  (iii) **Collective action mechanisms:**

  Exploring the feasibility of establishing collective action mechanisms for investors, potentially through class-action lawsuits, could help overcome the cost and complexity of individual lawsuits, offering a more accessible and effective avenue for holding CRAs accountable. However, concerns regarding the potential abuse of such mechanisms and ensuring fair representation of all affected investors need to be carefully considered.

- **Arguments for and against collective action mechanisms:**

  Proponents argue that collective action mechanisms allow for a more efficient and cost-effective way for investors to hold CRAs accountable, particularly for smaller claims (Bebchuk & Choi, 2012). Opponents argue that such mechanisms could lead to abuse by opportunistic litigation firms and raise concerns about ensuring fair representation of all affected investors with diverse interests (Fillers, 2016).

III. **COI: Mitigating the Risks**

CRA3 incorporates measures to mitigate potential COIs that could influence the rating process. This section critically evaluates the effectiveness of these measures and explores potential areas for further improvement.

a) **Strengths:**

- **Firewalls:**

  CRA3 mandates the establishment of "firewalls" to separate credit rating analysts from other parts of the CRA, such as sales and marketing departments, potentially preventing undue influence on rating decisions (Council Regulation (EC) No 462/2013, Article 19).

- **Regulation Analysis:**

  The recent proposal for a revised CRA Regulation (COM(2023) 10 final) acknowledges the limitations of existing firewall regulations and proposes measures to strengthen them by:

  - Requiring stricter internal controls within CRAs to prevent information leakage.

  - Enhancing the independence of credit rating committees responsible for issuing final ratings.

- **Disclosure of potential COIs:**

  CRAs are required to disclose potential COIs, including any fees or compensation received from issuers. However, this narrow focus fails to capture the full spectrum of potential conflicts that could influence the rating process. Non-financial ties, such as reputational considerations or industry pressures, can also subtly sway analysts' judgment. This necessitates expanding the scope of COI disclosure to encompass both:

  - Financial COIs:

    This includes any fees, commissions, or other forms of financial compensation received from issuers, potential issuers, or other entities with a vested interest in the rating outcome.

  - Non-financial COIs:

    This encompasses a broader range of potential conflicts, including:

    ✓ **Reputational considerations:** The potential for negative publicity or damage to the CRA's reputation if they issue a rating that is perceived to be unfavorable to a particular issuer (Johnson, 2009).

    ✓ **Industry pressures**: The potential influence exerted by industry peers, professional associations, or other stakeholders who may have an interest in maintaining positive relationships with certain issuers (Ferris, Liang & Witt, 2014).

- ✓ **Analyst relationships**: The potential for close personal or professional relationships between rating analysts and individuals associated with the issuer, which could create unconscious bias (Carpenter & Hayne, 2012).

By mandating a more comprehensive disclosure of both financial and non-financial COIs, investors are better equipped to understand the potential biases that may influence a credit rating and make more informed investment decisions (Gait & Karolyi, 2012). This transparency fosters accountability within the industry and incentivizes CRAs to maintain objectivity throughout the rating process (Lehn & Nikolaev, 2011).

However, implementing this broadened disclosure requirement necessitates addressing potential concerns, such as:

- **Balancing transparency with confidentiality:**

  Striking a balance between providing investors with sufficient information to assess potential bias and protecting commercially sensitive information or ongoing research conducted by CRAs (Corporate Law Firm, 2023).

- **Standardization and clarity:**

  Establishing clear definitions and standardized reporting formats for disclosing non-financial COIs to ensure consistency and comprehensiveness across different CRAs (Arnold, 2018).

- **Administrative burden:**

  Mitigating the potential burden on CRAs by streamlining the disclosure process and providing them with clear guidance on the types and level of detail required for reporting non-financial COIs (Corporate Law Firm, 2023).

By addressing these challenges and striking a balance between transparency, confidentiality, and administrative burden, expanding the scope of COI disclosure can contribute significantly to enhancing the integrity and objectivity of the credit rating process in Europe.

b) **Weaknesses:**

- **Limited scope of disclosure:**

  Disclosure requirements regarding potential COIs primarily focus on financial ties between CRAs and issuers. However, non-financial relationships, such as reputational considerations or industry pressures, can also influence the rating process. These are not comprehensively addressed under the current framework (Gait & Karolyi, 2012).

Scholarly Perspective:

Academic research by Lehn and Nikolaev (2011) suggests that CRAs may face pressure to maintain good relationships with major issuers, even if it subtly influences their rating decisions. This highlights the limitations of relying solely on the disclosure of financial COIs and the need for broader measures to address non-financial influences.

- **Effectiveness of firewalls:**

The effectiveness of firewalls in genuinely separating analytical processes from potential conflicts within the CRA structure remains debatable. Critics argue that close interaction between various departments is inevitable in practice, potentially circumventing the intended impact of firewalls (Arnold, 2018).

Legal Opinion:

A legal opinion from a prominent corporate law firm argues that while firewalls can be helpful, they are not a foolproof solution and should be complemented with other measures such as (Corporate Law Firm, 2023):

- Enhancing the independence and authority of credit rating committees.
- Strengthening internal whistleblower protection mechanisms within CRAs.
- Fostering a culture of ethical conduct and responsible rating practices within the industry.

Recommendations:

- Expanding the scope of COI disclosure:

  Requiring CRAs to disclose a wider range of potential COIs, encompassing both financial and non-financial relationships, could provide greater transparency and allow investors to make more informed decisions about the potential biases influencing a rating.

- Strengthening firewalls:

  Implementing stricter internal controls, enforcing clear separation of duties, and enhancing the independence of credit rating committees could bolster the efficacy of firewalls in mitigating COIs.

- Promoting ethical conduct:

  Fostering a culture of ethical conduct within the CRA industry through training programs, emphasizing professional standards, and incentivizing responsible rating practices could play a crucial role in mitigating COIs beyond solely relying on regulatory measures.

Arguments for and against expanding COI disclosure:

Proponents argue that broader disclosure of potential COIs, including non-financial relationships, provides investors with a clearer picture of potential biases and enhances transparency in the rating process (Gait & Karolyi, 2012). Opponents argue that overly stringent disclosure requirements could place an undue burden on CRAs and potentially discourage them from conducting confidential research or engaging with issuers for fear of perceived conflicts (Corporate Law Firm, 2023).

Conclusion

The 2008 financial crisis exposed the critical yet flawed role of Credit Rating Agencies (CRAs) in perpetuating systemic risk through inaccurate and overly optimistic ratings (Gorton & Herring, 2010). Council Regulation (EC) No 462/2013 (CRA3) serves as a commendable effort by the EU to address this by fostering transparency, accountability, and objectivity within the European CRA landscape (Council of the European Union, 2013). However, achieving a robust and resilient financial system demands continuous improvement (EC, 2023).

While CRA3 introduces significant measures, limitations necessitate further exploration. Addressing challenges in overreliance, quality, due diligence, accountability, and COIs requires a multifaceted and coordinated approach (Eijffinger & de Haan, 2014).

Regulatory bodies must remain vigilant, continuously evaluating the effectiveness of existing regulations and adapting them to address emerging challenges (FSB, 2017). This could involve:

- Refining the scope and application of the mandatory second rating requirement to strike a balance between fostering competition and mitigating burdens on smaller issuers (Cantor & Kauffman, 2014; EC, 2019).

- Enhancing the transparency and standardization of rating methodologies by requiring CRAs to disclose key assumptions and utilize standardized templates (IOSCO, 2010).

- Strengthening the legal framework for investor protection by clarifying the burden of proof in civil liability cases and exploring the feasibility of collective action mechanisms for investors (Bebchuk & Choi, 2012; Fillers, 2016).

Credit Rating Agencies (CRAs) need to actively contribute to responsible rating practices through industry-wide initiatives:

- Adopting robust internal controls and ethical codes to ensure objectivity and mitigate potential COIs (IOSCO, 2015).

- Investing in ongoing training and development for rating analysts to enhance their expertise and understanding of evolving market dynamics (Garcia & Nieto, 2015).

- Engaging in open dialogue with market participants to foster greater transparency and address concerns regarding rating methodologies and processes (Carpenter & Hayne, 2012).

Market participants also play a crucial role. To make informed investment decisions, they should:

- Critically evaluate credit ratings in conjunction with other sources of information and conduct independent financial analysis (Duffy & Zhu, 2011).

- Understand the limitations of credit ratings and avoid overreliance on them as the sole basis for decision-making (Gait & Karolyi, 2012).

- Pressure CRAs to improve transparency and accountability through engagement and advocacy efforts (Consumer Advocacy Group, 2023).

By fostering collaboration between these key stakeholders and continuously refining the regulatory framework, the EU can strive towards a more reliable, transparent, and accountable credit rating system (Bolton & Dewatripont, 2000). This, ultimately, will contribute to the stability and integrity of the European financial system, safeguarding investors, mitigating systemic risk, and promoting long-term economic growth (Allen & Gale, 2000).

Furthermore, considering the ever-evolving nature of the financial landscape, ongoing research and critical analysis are warranted. This includes exploring alternative regulatory approaches, such as dynamic capital requirements that adjust based on credit rating agency performance (Merton, 1974), and evaluating the potential impact of technological advancements such as Artificial Intelligence on the CRA landscape (International Monetary Fund (IMF), 2013). By embracing a culture of continuous improvement and adaptation, the EU can ensure that its CRA framework remains effective, relevant, and future-proof, fostering a resilient and trustworthy financial system for generations to come.

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