Fitch Ratings

BY ELECTRONIC MAIL: www.esma.europa.eu

14 February 2013

European Securities and Markets Authority ("ESMA")

Re: ESMA's Consultation Paper on Guidelines and Recommendations on the Scope of the CRA Regulation

Ladies and Gentlemen:

Fitch Ratings ("Fitch") submits this letter in response to the invitation for comments from ESMA on its Consultation Paper (the "Paper'), dated 20 December 2012, on guidelines and recommendations on the scope of the CRA Regulation. We set out our responses below to only those questions with respect to which we have comments.

Question 1. Do you agree with the approach set out above on the obligation to register?

We think it is very important that ESMA clarifies an assertion it makes with respect to CRAs established outside the EU that are of "systemic importance" to the financial markets of one or more Member States. ESMA claims that, because the ratings of such CRAs can only be used for regulatory purposes if they are endorsed, "[a]s a consequence, when such credit rating agencies intend to conduct credit rating activities in the Union and distribute their ratings to the public, they shall always establish legal persons and obtain registration in the Union under the CRA Regulation." We assume, consistent with the CRA Regulation, that ESMA does not mean that CRAs established outside the EU cannot rate issuers established in the EU and securities issued in the EU. Of course, such ratings cannot be used for regulatory purposes by entities referred to in Article 4(1) of the CRA Regulation unless they are endorsed under Article 4(3). However, there is nothing in the CRA Regulation – nor should there be – that prevents such CRAs from issuing such ratings. We strongly urge ESMA to add language to that effect in the Proposed Guideline set out at paragraph 26.

Question 3. Do you agree with the explanation of credit ratings provided in this document?

In the Overview portion of the section 4 of the Paper, ESMA makes the following assertions: "Qualitative input from credit analysts, however, is a complement and not a substitute for the use of techniques that ensure consistent treatment of quantitative data. A rigorous, continuous and systematic rating methodology may therefore involve the use of pre-set analytical instruments, such as scorecards, models or other statistical tools, along with a clear indication of how, when and according to which criteria analysts' judgment is to be exercised." This language seems to imply that ESMA is dictating the contents of a CRA's methodology. For

example, a CRA may choose the opposite approach – that is, it may use quantitative data as a complement to the qualitative input from credit analysts. Such an approach is equally valid. It is therefore important to underline the fact that ESMA is expressly prohibited from interfering with the content of methodologies, or credit ratings, under Article 23 of the CRA Regulation. We therefore think it should be made very clear that, at the end of the day, the CRA is responsible for creating its own methodologies, and that ESMA is not trying to interfere in the content of those methodologies (as specified by the CRA Regulation). Indeed, we note that the proposed guideline is much less prescriptive: "Credit ratings, as defined in the CRA Regulation, should include not just quantitative analysis but also sufficient qualitative analysis, according to the rating methodology established by the credit rating agency. A measure of creditworthiness derived from summarising and expressing data based only on a pre-set statistical system or model, without any additional substantial rating-specific analytical input from a rating analyst, should not be considered as a credit rating."

Question 5. Do you agree with the explanation of private ratings provided?

We note that the proposed guideline at paragraph 42 would require CRAs which provide private ratings to include restrictions in their fee letters regarding the distribution of private ratings: "In accordance with Article 2(2)(a), credit rating agencies should ensure that the agreements for the issuance of private ratings cover the duty of confidentiality and limitations on the distribution of the ratings. In issuing private ratings credit rating agencies should inquire whether the person who placed the order, as recipient of the private rating, has any intention to use the rating in a way that would bring it into the public domain or to use it for regulatory purposes. Where the credit rating agencies can reasonably conclude that a private rating is to be disclosed to the public, it shall refrain from issuing that rating."

We have several objections and concerns with respect to this proposed guideline. First, we do not see how Article 2(2)(a) imposes such a requirement. Second, it is not for the CRA to police the uses to which ratings are put. As the CRA Regulation itself provides in Article 25a, whether an issuer uses such a rating for regulatory purposes is a matter for the sectoral competent authorities. Third, credit rating agencies have no meaningful tools to police an obligation on the issuer regarding restrictions on its distribution of private ratings – again, this is within the scope of responsibilities and powers of the relevant sectoral competent authorities. Finally, we are concerned about the vagueness of the requirement not to issue a private rating if the CRA "can reasonably conclude" that the issuer will disclose the rating to the public. What are the criteria for such a "reasonable conclusion"? Again, this requirement seems to place an unreasonable burden on the CRA.

We do accept that if a CRA chooses to publish a hitherto private rating, such CRA should ensure, prior to publication, that such rating complies with the relevant requirements of the CRA Regulation. However, if an issuer publishes such rating first, the CRA should not be penalized; it has no power to control the behavior of the issuer. Instead, once the CRA is made of aware of the publication, it should then be able immediately to publish the rating itself (to ensure that the rating and any related information are current and complete) and should be allowed adequate time thereafter to ensure that such rating complies with the relevant requirements of the CRA Regulation.

Question 6. Do you agree with the approach taken in the text above regarding the establishment of branches of registered credit rating agencies outside the Union?
Question 7. Do you agree that credit rating agencies should demonstrate that there is an objective reason to conduct certain credit rating activities in branches established outside the Union?
Question 8. Do you agree that ESMA's capacity to deliver effective supervision would be impaired where credit rating agencies conducted entirely or prevalently important operational functions, and in particular credit rating activities, in branches outside the EU?

We agree that a CRA registered with ESMA should be responsible to ESMA for the credit rating activities of any of its branches located outside of the EU, since a branch does not have a legal personality separate from the registered CRA. We note that the major reason for establishing such branches, rather than subsidiaries, will be prudent tax planning. There may also be corporate governance and liability questions involved in the decision. Since it is not clear to us what is meant by an "objective reason" for establishing such a branch, we believe that the standard should instead be that such branches cannot be established solely as a means of circumventing the CRA Regulation.

However, we also note that the third country in which the branch is established may itself have regulations governing the conduct of credit rating activities. We believe it is therefore important that ESMA recognizes the application of such regulations, and is mindful of the potential for contradictory requirements being placed by the third country regulator on the credit rating activities of the branch.

In the Paper, ESMA seems to be calling into question a standard corporate practice of creating an EU entity which then sets up a branch in an emerging market, rather than setting up the subsidiary directly in the emerging market. We see no reason for such practices to be forbidden, provided that the CRA cooperates with ESMA to provide ESMA with access to any documents and employees that ESMA reasonably needs to fulfill its supervisory obligations under the CRA Regulation. Moreover, we note that it is common for banks to set up branches in third countries and for the banks' regulators in the relevant countries to cooperate in supervising those banks and their branches. The concept of coordinated and consolidated supervision is well established and understood by bank regulators, and such coordinated supervision can easily be undertaken by ESMA with respect to CRAs.

If ESMA does not have some form of cooperation agreement with the relevant regulator in the third country, then it should obtain from the registered CRA a legal memo providing assurance that nothing in the laws and regulations of that third country will prevent ESMA from fulfilling its supervisory obligations under the CRA Regulation with respect to such branch. On this basis, the branch may contain whatever operational functions are necessary to carry out the relevant credit rating activities in that branch. Again, we point out that the regulations in the third country might require certain functional operations to be based in such branch; provided that ESMA has the ability to perform its supervisory duties, as outlined above, it should be left to the CRA to determine how to structure its operations.

We note ESMA's assertion with respect to the compliance function, at paragraph 48, that "some level of relevant staff should be present in the branches established outside the

European Union". We are not sure exactly what is meant by this assertion. We believe it is important for the registered CRA to have flexibility, given the size of any of its non-EU branches, to determine the best way to ensure that compliance obligations are fulfilled. For example, we agree with ESMA's implication that it is not necessary to have a compliance officer in the branch; compliance officers located in the EU can be assisted by other employees in those branches on an ad hoc basis – and we note that the CRA Regulation specifically provides for such a scenario in Annex I, Section A, paragraph 6(c).

Given the above discussion, we would urge ESMA to make the following amendments (in bold typeface) to its proposed guidelines (using the numbering in the Paper), as well as to the corresponding discussion in the paragraphs preceding such guidelines:

52. Since branches do not have a separate legal personality from their parent, credit ratings issued in branches established outside the Union are deemed to be issued by their EU parent. Therefore, infringements by the branches of the CRA Regulation are attributable to the parent CRA which shall be the object of ESMA's enforcement actions. **However, enforcement actions will not be taken in the event of a conflict between the provision of the CRA Regulation allegedly infringed and the laws, regulations and rules of the relevant third country. Instead, ESMA will engage in a dialogue with the relevant third country regulator with a view to eliminate such conflict.**

[DELETE: 53. ESMA would risk being prevented from performing its supervisory tasks if the important operational functions of credit rating agencies were based and primarily operated outside the Union. Therefore, ESMA would take action according to Article 24, 36a, 36b, namely due to infringements by the CRA of Annex III part II points 2, 4, 5, 6, 7 and 8 of the CRA Regulation.] **[Note: This proposed guideline should be deleted in its entirety, as the relevant issue is covered in the proposed guideline set forth in paragraph 54.]**

54. Credit rating agencies shall not establish branches in third countries to perform activities that are subject to supervision by ESMA if this prevents ESMA from conducting supervisory tasks in relation to **such activities of** those branches as set out in articles 23b to 23d of the Regulation, including the ability to carry out on-site inspections and investigations. In this respect:

a) credit rating agencies should cooperate with ESMA in case of inspections or investigations, including on-site visits, regarding **credit** ratings or **credit** rating activities carried out in non-EU branches;

b) ESMA will assess the need to enter into cooperation arrangements with the local competent regulators to ensure the adequate supervision of branches located outside the Union;

c) prior to establishing branches in third countries, credit rating agencies should ensure that those branches will comply **[DELETE:** immediately] **promptly** with any request set forth by the officials of ESMA in the exercise of powers pursuant to Articles 23b to 23d of the CRA Regulation, including granting of access to premises, systems and resources in the case of on-site inspections and investigations.

69. ESMA shall impose periodic penalty payments in order to compel the credit rating agency to put an end to the infringement of issuing credit ratings without being registered by ESMA, and impose fines where appropriate, in accordance with Articles 36(a) and 36(b) of the CRA Regulation. This applies also to registered credit rating agencies [**DELETE:** that create impediments to the effective supervision from ESMA by carrying out entirely (or prevalently) important operational functions in branches outside the EU] **with branches outside the EU in the event any such registered credit rating agency does not cooperate with ESMA in case of inspections or investigations, including on-site visits, regarding credit ratings or credit rating activities carried out in any such branches.**

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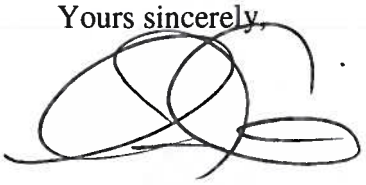
Thank you for giving us the opportunity to provide our comments. We hope that you find them useful, and that you will give them due consideration. Please do not hesitate to contact me in London at +44 20 3530 1368, or at susan.launi@fitchratings.com, should you wish to discuss this matter further.

Yours sincerely,



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