STANDARD & POOR'S RATINGS SERVICES RESPONSE TO CESR CONSULTATION PAPER

4 DECEMBER 2009

INTRODUCTION

S&P Ratings Services ("S&P") is grateful for the opportunity to respond to the CESR Consultation Paper issued on 21 October 2009. We do not propose to repeat in this document all the points that we have made in past correspondence with CESR, although we maintain the positions previously expressed.

We reiterate that we stand ready to work with CESR to deliver a framework which addresses the objectives of the EU CRA Regulation ("*the Regulation*") in a manner that will avoid unnecessary resourcing and compliance costs for CESR, national supervisors and the CRAs which are to be subject to its provisions.

We provide below our comments on issues raised by the Consultation Paper, in the order in which they are addressed in it. Paragraph references are to paragraphs in the Consultation Paper.

GUIDANCE ON REGISTRATION PROCESS

Application for registration: language requirements and process

Paragraphs 26 – 28: S&P appreciates that all members of the relevant college need to be in a position to assess an application for registration and that this would be assisted by translations being made available for certain documentation. However, from S&P's perspective, we would point out that obtaining translations can be extremely costly and may cause significant delays, in particular bearing in mind the extent of supporting documentation required under Annex II of the Regulation, such as policies, procedures and description of methodologies.

In this regard, we note that the European Commission has proposed that national competences over CRAs will be transferred to ESMA in January 2011. Given the short period between the date that applications for registration will have to be submitted (by nine months after the Regulation coming into force, i.e. by 7 September 2010) and the expected transfer of competence to ESMA, we would suggest that it would be most efficient for all documents to be submitted only in ESMA's working language, if that has been determined at that stage.

An alternative approach, including in the case where ESMA's working language is not known at the time applications are due, may be one which has already been put into practice for ECAI applications under the Capital Requirements Directive, which is that only "*local information*"' (i.e. information specific to a particular member of the CRA group) or a cover letter is provided in the local language and that the general information common to all group

members is provided in English (being a language customary in the sphere of international finance).

We note that in relation to the processes for adoption of registration or refusal decisions by competent authorities, there does not appear to be any provision for applicants to appeal against a decision refusing registration. Whilst such processes would presumably be determined by reference to the national requirements of the competent authority of the relevant home Member State, it would nevertheless be helpful for CESR to issue guidance on the topic. We also believe – by reference to paragraphs 57 to 61 of the Consultation Paper - that any decision to publish information around a refusal or withdrawal of registration should only be made after the applicant/registered CRA had been afforded an opportunity to challenge that refusal or withdrawal (as referred to in paragraphs 130 and 131).

GUIDANCE ON THE PROCEDURE FOR ENDORSEMENT

Approval for endorsement

Paragraph 66: S&P respectfully disagrees with the proposal that the procedure for registration should also be used in relation to the giving of an approval to allow CRAs to endorse ratings.

The only requirement set out in Article 4 of the Regulation is that the CRA must be able to demonstrate that it satisfies various ongoing conditions in relation to its home Member State regulator (see, for example, Articles 4.3(b), (d) and (h)). Article 4 does not state that, once registered, a CRA will be required to go through any separate or further approval procedure before it can endorse ratings. The Regulation does not provide for a process that requires scrutiny by the college and CESR should therefore not create one.

In relation to paragraph 74, we do not see the need for an additional process whereby CESR would publish lists of third countries from which CRAs were able to endorse. The Regulation does not provide for such a process.

Equivalence* and *endorsement

We would draw attention to the fact that endorsement and certification/equivalence are clearly expressed in the Regulation to be separate and distinct concepts - in paragraph 63 of the Consultation Paper, they are described as "*distinct mechanisms*". The Regulation does not state that the application of the endorsement regime should be dependent on a finding of equivalence.

The Regulation makes it clear that, while certification requires a finding that the third country's ***regulatory regime*** is "*equivalent to*" that established in the EU by the Regulation, the endorsement mechanism requires only that the ***conduct of a specific CRA*** in a third country can be shown to fulfils requirements "*as stringent as*" those required of EU CRAs by

the Regulation. The wording of the Regulation permits a third party CRA to follow such standards of conduct on a voluntary basis.

Paragraphs 86 – 90: We suggest that there is an important and principled difference between the tests of "*at least as stringent as*" (used in the context of endorsement) and "*equivalent to*" (used in the context of certification). If no difference had been intended, then the Regulation would not have adopted two differently worded tests.

The phrase "*as stringent as*" requires a focus on whether the end results of the quality assurance and controls surrounding a particular third country CRA are, as a matter of fact, functionally equivalent to those under the Regulation. By contrast, the concept of "*equivalence*" is concerned with whether, as a matter of law, there is a sufficiently close match between official regulatory procedures and legal requirements in a third country and those required by the Regulation.

In other words, "*at least as stringent as*" suggests a focus on ***ends*** rather than ***means***, to a greater extent than does the phrase "*equivalent to*". This makes a great deal of sense since, in the case of endorsed ratings, the CRA endorsing the ratings, and giving assurances about the conduct of the third country CRA, will be directly regulated in the EU: there is thus scope for some flexibility in assessing whether the relevant third country CRA follows similarly "*stringent*" standards (whether or not it finds itself within an "*equivalent*" regulatory framework in that third country).

In this context we refer CESR to the closing words of Recital 13, which refers to "*requirements ... which are as stringent as those provided for in this Regulation,* ***achieving the same objective and effects in practice***" [*emphasis added*].

In this light, we believe that guidance is required as to the types of arrangements and standards that will be accepted as being "*at least as stringent as*" the requirements of Articles 6 to 12 of the Regulation. This guidance should be provided while bearing in mind that what is important in terms of the endorsement procedure is the ***standard of conduct*** of particular third country CRAs, as demonstrated by endorsing EU CRAs to their home competent authorities, and not the overall regulatory structure of a third country. The need to produce this guidance should not be avoided by conflating the endorsement and equivalence procedures.

Paragraphs 92 – 100: We suggest that the Regulation is clear that whether there has been a finding that a third country regulatory regime is "*equivalent to*" that in place in the EU should ***not*** determine whether the relevant third country CRA can be shown to be meeting standards "*at least as stringent*" as those set out in the Regulation. Contrary to what we understand to be the current interpretation, we would urge CESR to confirm that these tests are separate and independent.

Significantly, the test in Article 4.3(b) of the Regulation is whether the "***conduct*** of credit rating activities by the third-country credit rating agency" [*emphasis added*] meets standards "*as stringent as*" those in the Regulation – ***not*** whether the supervisory regime in that third country is equivalent. This is why Article 4.6 provides that an equivalence decision is ***sufficient*** to fulfil the test in Article 4.3(g), but it is not ***necessary***. This means that an endorsing CRA, in the absence of a relevant finding of equivalence, is still permitted to point to a set of standards followed by a third country CRA that achieves the same outcomes as those that Articles 6 to 12 are intended to promote. Amongst other factors, we suggest that weight should be given in this regard to procedures maintained by the third country CRA that achieve compliance with the equivalent provisions in the IOSCO Code.

We would suggest that a negative equivalence finding should not lead to any presumption against satisfaction of the requirements of Article 4.3 of the Regulation, which is concerned with evaluating the conduct of specific third country CRAs, whose standards are being vouched for by EU-registered CRAs. That evaluation should not be prejudiced by the existence of a negative equivalence decision in relation to the third country regulatory structure as a whole. For Article 4.3, it is the conduct of the specific third country CRA that is being assessed, not the wider regulatory structure surrounding it. The former is the subject of the evaluation for endorsement, while the latter is only directly relevant in the context of certification.

We note the concerns about relying on EU CRAs to provide assurances about the conduct of third country CRAs whose ratings are to be endorsed. It has been suggested that this situation is unsatisfactory, and that endorsement should only be possible where the mandatory regulatory standards applied to third country CRAs (and not merely their own standards and safeguards) are equivalent to those applied to EU-registered CRAs under the Regulation. We do not understand these concerns, and we do not see why they should lead to a merging of the "*as stringent as*" and "*equivalent to*" tests. The fact is that, under the terms of the Regulation, endorsement is permitted if the third country CRA follows standards that are at least as stringent as those required under the Regulation. The Regulation does not require that those standards should be legally embedded in a third country's regulatory regime.

Recital 13 is clear on this point:

> *"... When endorsing a credit rating issued in a third country, credit rating agencies should determine and monitor, on an ongoing basis, whether credit rating activities resulting in the issuing of such a credit rating comply with requirements for the issuing of credit ratings which are as stringent as those provided for in this Regulation, achieving the same objective and effects in practice."*

In other words, the Recital envisages that, for purposes of endorsement, it is for the EU-registered CRA to "*determine and monitor*" the standards applied by the third country CRA, and not for anything to be determined by reference to an equivalence decision of the

Commission. Further, what is to be determined is simply whether the "*credit rating activities*" of the third country CRA "*comply with requirements*" (not, it should be noted, "*legal requirements*" or "*regulatory requirements*", but simply "*requirements*") as stringent as those in the Regulation. It does not matter whether that compliance is as a result of a third country regulatory system that legally embeds the requirements of the Regulation, or is the result of standards applied by the third country CRA as a result of (for example) group policy.

The wording of Article 4.3(b) is entirely consistent with the wording in Recital 13 in that it again refers to the ***conduct*** of a third country CRA and it refers simply to "*requirements*". Furthermore, both Recital 13 and Article 4.3(b) state that the endorsing CRA in the EU must monitor the compliance of the third country CRA with the applicable standards. There would be no value in this obligation if, in all cases of endorsement, the third country CRA's adherence to those standards was enforced by a regulator in that country. In fact, we believe that in that situation this obligation would be unhelpful. It would effectively mean that, in relation to every endorsed rating, the third country CRA would be subject to two sets of supervision, namely direct supervision by its home regulator and indirect supervision (through the endorsing EU-registered CRA) by EU supervisors.

It is also clear from the provisions of paragraphs (f) to (h) of Article 4.3 that the applicable standards required under Article 4.3(b) do not have to be enforceable by a regulator in the third country.

Article 4.3(f) requires that the third country CRA be subject to domestic regulatory supervision. It does not, however, require this supervision to be equivalent to the supervision provided for EU-registered CRAs under the Regulation.

It is also particularly significant that Article 4.3(g) singles out as an express requirement the fact that there must be no scope for regulatory interference with credit ratings in the third country. If Article 4.3(b) were interpreted as requiring third country regulation to be equivalent to that established by the Regulation in the EU, then Article 4.3(g) would be wholly redundant. Further, the requirement in Article 4.3(h), that there should be co-operation arrangements in place between the EU competent authority and the third country regulatory authority, does not require an equivalence of regulatory frameworks. Regulatory authorities across the world routinely co-operate with one another, even when there are differences between the detailed standards that they each enforce.

Article 4.6 is also highly relevant, in that it states that in cases where the Commission has recognised the regulatory regime in another jurisdiction as being equivalent under Article 5, it will no longer be necessary for the endorsing CRA to verify or demonstrate that the condition in Article 4.3(g) is fulfilled. It is significant that this exemption only focuses on the requirement of the Regulation that relates to analytical independence, and not the other numerous requirements. This demonstrates that Article 4.3(b) only focuses on the conduct of

the third country CRA, and not the requirements of the regulatory regime within the third country. Otherwise, there would be no point in requiring the endorsing CRA to evaluate the requirements of the third country regime against the requirements of Article 6 to 12 of the Regulation, because the Commission itself will have done that before issuing an equivalence decision (please see Article 5.3(b)).

When Article 4.3(f) to (h) come into force, therefore, what will be required is that third countries from which endorsed ratings originate must have some level of domestic CRA supervision, that this supervision must not interfere with the independence of credit ratings, and that there should be co-operation arrangements in place between local supervisors and EU competent authorities. These provisions do not require that third country regulatory systems must be equivalent to those in the EU, or must apply equivalent standards. The key test, before and after the coming into effect of Article 4.3(f) to (h), is the test contained in Article 4.3(b) – that is, whether the third country CRA observes standards as stringent as those required by the Regulation, irrespective of whether or not such observance is mandatory under local regulatory requirements.

For those reasons, it is clear that any attempt to interpret Article 4.3 as requiring equivalence of third country regulatory regimes would contradict the clear words of the Regulation. It could also produce a wholly undesirable level of market disruption. It could effectively prevent non-EU ratings being endorsed by EU-registered CRAs, and therefore prevent them being used by EU institutions. This is not the intention of the Regulation, and we would urge CESR not to risk this potential outcome by conflating the distinct and separate tests for endorsement and for certification. Although Article 21 provides for CESR to give guidance concerning the operation of the endorsement regime, any guidance must be consistent with the wording of the Regulation itself. It would be unacceptable for guidance to be used effectively to amend the Regulation.

Identification of endorsed ratings

Paragraph 71: While S&P recognises that the Regulation in Article 4.2 requires that a CRA "*clearly identify […] that the credit rating is endorsed*", we would welcome CESR's confirmation that such an identification would not require a separate "*identifier*" and that the appropriate disclosure may be made in ratings publications. Having a separate identifier would contrast with the letter and spirit of the Regulation, which in Article 4.4 states that a "*credit rating endorsed in accordance with paragraph 3 shall be considered to be a credit rating issued by a credit rating agency established in the Community and registered in accordance with this Regulation*."

Timing of provision of client lists

Paragraph 111: We do not agree with the proposal that CRAs should have to provide disclosure of a list of significant clients within three months after the end of the CRA's

financial year. Adopting a deadline of three months after the financial year-end would be inconsistent with existing financial services legislation, including the Transparency Obligations Directive[1], which (in Article 4) provides for a four month period. As the Regulation does not provide for any deadline, we would propose that each CRA should agree a workable deadline with its home Member State regulator(s), having regard to existing legislative and practical requirements.

GUIDANCE ON COLLEGES

Selection of facilitator

Paragraphs 113 – 115: S&P agrees that the factors listed may be relevant in selecting a facilitator for a particular CRA. A particularly important factor is "*past experience/interaction with the agency*"; in light of the timeframes for implementing the new regulatory regime for CRAs, it is sensible to draw as far as possible on the knowledge already held by potential facilitators in relation to certain CRAs.

Need for cross-college consistency

Paragraph 119: S&P agrees that there is a need for cross-college consistency and that CESR has an important role in ensuring this. We are encouraged that this is a clear objective for CESR. In addition to the suggestions set out in the paper, we would suggest that CESR should consider collecting and promoting best practices for colleges and facilitators.

Majority views / voting

Paragraph 124: We welcome the clear statement that CESR is "*not seeking to introduce majority voting*", and that final decisions properly lie with "*individual competent authorities*". S&P agrees that a home competent authority should, under the Regulation, "*give due consideration*" to the views of other members of the college when making certain decisions. But it is important to be clear that a duty to consult other college members before taking supervisory measures is quite different from any sort of majority voting.

Location of issuance and impact on supervisory responsibility

Paragraph 141: S&P agrees that there is a need to address the risk that "*the supervisory actions of more than one competent authority could create confusion and potentially lead to conflicting positions*". We also agree that, as a result, it is desirable for there to be only one home competent authority allocated in relation to each rating.

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[1] Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC

Paragraph 143: We welcome the inclusion of "*possible criteria*", which indicates that the list of criteria is non-exhaustive. If a single "*office*" is to be designated as responsible for a rating, for the purposes of allocating a single home competent authority, we would suggest that it is the office that has had an important overall role in the production of the rating, and which will have ready access to relevant personnel (at both analyst and management level) and documents. This will enable the office to liaise effectively with the home competent authority. We suggest that the fixed rules as to issuance would not reflect the complexity and diversity of the ratings processes that result in each individual rating. Consequently, the application of such rules could lead to inappropriate results in determining the proper home competent authority. The allocation of a rating to a particular office should ultimately be a decision for the relevant CRA to take, by reference to the type of criteria listed as well as any other relevant factors.

We would, therefore, not support the introduction of automatic criteria to be applied to this question. Instead, we would suggest that the principle of clearly linking ratings to a single member state should remain, but that it should be left to CRAs to confirm which office issues each rating, after taking into account not only the factors set out in paragraph 143, but also all the other circumstances surrounding the rating - no single factor should be decisive.

GUIDANCE ON THE INFORMATION SET OUT IN ANNEX II

ECAI requirements

Paragraph 162: We have no objection to the inclusion of additional ECAI information requirements, provided it is clear that this will not require CRAs that are currently ECAIs to re-submit their applications for ECAI status.

Policies and procedures

Paragraph 160: We would suggest that the breadth and scope of the information to be submitted in the application process, as contemplated in the Consultation Paper, covers much more than should be needed to determine eligibility under the terms of the Regulation itself. For example, paragraph 160 states that the term "*policies and procedures*" includes "*any document internal and external to the applicant*". This is very broad and potentially extremely burdensome. We would appreciate clearer guidance from CESR on what level of information it is reasonable to provide in this context. While we will of course be happy to provide our public statements of policy, together with our internal guidelines, we would welcome clarification that the reference to "*any document internal and external*" is not intended to widen this obligation. In particular, we assume that the reference to "*external*" documents means only those external documents that a CRA incorporates into its own code of conduct.

Historical data

Paragraph 166: We welcome CESR seeking our views on the issue of requirements to produce historical data. We believe that the key issue is that of proportionality. We do not think it is proportionate to require CRAs to submit information relating to periods long before the application of the Regulation. Given that CRAs have not previously been supervised at the European level, and have only relatively recently come under supervision in other jurisdictions (including the US), it is not clear to us how CRAs can be expected to have had certain formalised functions, policies, procedures and data collection systems in place by reference to a piece of legislation which is not yet in force. Some of the historical information sought may simply not exist. We would therefore suggest that the Guidance should not contain requirements for the provision of information relating to periods before the coming into force of the Regulation. The Regulation does not require this information to be provided.

Paragraph 173: We view it as significant that there are only two references to "*detailed information*" in the Regulation (in paragraphs 16 and 17 of Annex II). We see this as reflecting a desire to avoid placing excessive burdens on CRAs. Yet in the Consultation Paper, there are several other references to "*details*". The fourth bullet point of paragraph 173, for example, refers to "*details of whether the applicant produces solicited or unsolicited ratings (or both)*". We consider that a reasonable answer to this question would simply be a confirmation that a CRA produces only solicited ratings, only unsolicited ratings, or both. We do not think it is clear what further "*details*" CESR has in mind, or that it is appropriate to request them.

Corporate governance

Paragraph 179: In our view, the Consultation Paper does not adequately take into account the current organisational structure of global CRAs such as S&P, which are organised along functional lines rather than as a group of stand-alone entities. Although separate legal entities may exist in different countries to satisfy legal requirements or for other practical reasons, these entities are not stand-alone CRAs in their own right, but parts of S&P – which is a single, global operation. We would request that CESR should explicitly recognise that where a group of CRAs operates as a single functional group, certain horizontal functions as are listed in the corporate governance section (including compliance, internal control/audit, risk assessment, internal review) may be addressed at the global group level.

For example, CESR could require that, where certain functions are not fulfilled at the individual legal entity level, it would be open to the CRA to explain how it achieves compliance with the Regulation at the group level. We note that international CRAs are organised on a global basis with a view to achieving an approach to their ratings which is consistent across jurisdictions. Not taking into account such organisational structures could impact the international consistency of credit ratings.

Compensation

Paragraph 186: The first bullet point goes beyond what is properly required by the Regulation, by requiring disclosure of compensation policies for "*Senior Management and the compliance function*". Neither senior management nor the compliance function will be involved in the issuing of ratings, the latter as a result of the prohibition in point 6(c) of Section A of Annex I.[2] It would, accordingly, be disproportionate to require disclosure of their compensation policies. Further, the second bullet point goes beyond the Regulation by requiring the disclosure of *levels* of compensation, rather than simply compensation *policies*.

Information not required by the Regulation

Paragraphs 195 – 200: As a general comment, we would observe that CESR seems to require the submission of information beyond that which is listed in Annex II. Article 13 of the Regulation provides that the application "shall **contain** information on the matters set out in Annex II" - it does not say "shall **include** ..." [*emphasis added*].

In this light, we would suggest that the relevant information requirements should be limited to the information in the first bullet point of paragraph 196, the first bullet point of paragraph 198, and the third bullet point of paragraph 200. In each of these paragraphs, the other bullet points all contain information requirements that are not justified by reference to the Regulation, and not necessary for its implementation. We do not think it appropriate for CESR to seek to impose information requirements that go beyond the very specific requirements set out in the Regulation itself. This would increase burdens on CRAs without there being any justification in the text of the legislative measure.

Endorsement

Paragraphs 201 – 210: We refer to our comments above on endorsement.

We look forward to further engagement with CESR in relation to the points we have raised above and will be pleased to provide additional comments and input as needed.

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[2] "*the managers, rating analysts, employees and any other natural person whose services are placed at the disposal or under the control of the credit rating agency or any person, directly or indirectly linked to it by control, who is involved in the compliance function must is not be involved in the performance of credit rating activities they monitor*"