



Moody's Investors Service Ltd.

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Response to the Consultation Paper on the Advice on the Possible Level 2 Implementing Measures for the Proposed Prospectus Directive

1. Executive Summary

- 1.1 Moody's Investors Service (Moody's)¹ welcomes the opportunity to submit this letter in response to the consultation paper² (the Consultation Paper) prepared by the Committee of European Securities Regulators (CESR) in relation to its advice on Possible Level 2 Implementing Measures for the Proposed Prospectus Directive³ (the Directive) by the European Commission (the Commission).
- 1.2 As a bond rating agency, Moody's is an intensive user of publicly available information in the European market. To that end, we refer you to Annex 1 of this document wherein we summarise the role of rating agencies in general and the process of producing and disseminating a Moody's rating in particular. Moody's has long been an advocate of timely and meaningful financial disclosure among market participants. We firmly believe that transparency bolsters investor confidence and allows for the more efficient flow of resources in capital markets. As such we applaud the Commission and CESR for proposing a regulatory framework that aims to improve the availability of information in the capital markets.
- 1.3 We would be happy to discuss in further detail with you, over the coming months, our views on the various provisions of the Directive and or CESR's advice. This comment letter will offer only our thoughts on the one aspect of the Consultation Paper that relates specifically to rating agencies.
- 1.4 Paragraph 259 of the Consultation Paper (Paragraph 259) addresses disclosure requirements under Section V.A. and raises two broad questions: 1) ought issuers be

¹ Moody's ultimate parent company is Moody's Corporation (MCO).

² Dated October 2002, Ref: CESR/02.185b.

³ Dated 31 October 2002, 13593/1/02 REV 1.

required to disclose ratings assigned to them or their securities in a registration document; and, if so, 2) what is the best means of ensuring meaningful disclosure.

- 1.5 We note that compelling issuers to disclose ratings in prospectus documents may be redundant for several reasons. First, ratings assigned by major rating agencies are already widely and freely available in the public domain. Second, as issuers are obligated under the Market Abuse Directive⁴ to disclose, on a real-time basis, any changes in their circumstance,⁵ it is our current understanding that as a consequence of CESR's advice to that directive⁵, it is likely that ratings and rating changes will be required to be disclosed by that directive. Moreover, it is our perspective that disclosure of a rating in the prospectus document may unintentionally confuse investors in the event of a rating change. As indicated in Annex 1, Moody's ratings are continuously monitored and updated as appropriate, with any rating changes being broadly disseminated through a press release and made available on our web-site. For example, if Moody's changed a rating after a prospectus document was published, the investor could be presented with conflicting information and would have to decide whether the rating in the prospectus or the rating made available in the public domain by the rating agency was the current rating.
- 1.6 However, should CESR decide that ratings are to be disclosed in the prospectus document we would recommend the following changes to Paragraph 259:
- a) institutions whose ratings are disclosed should be limited to "rating agencies";
 - b) "rating agencies" should be clearly defined within the meaning of the Directive as *"entities whose primary business is the issuance of credit ratings made broadly available to the general public for the purpose of evaluating the credit risk of debt securities"*; and,
 - c) where there has been a rating change, the content of the disclosure should be the rating, and the issuer's analysis as to the effect of the rating on the issuance of its securities. In other circumstances, the issuer should be permitted to cross-refer to the relevant rating agency's web-site and should not be required to "explain the meaning of the rating".

2. Disclosure of Ratings in the Registration Document

- 2.1 In relevant part, Paragraph 259 asks:

"Should information about the rating of the issuer or of the issues be mentioned under that item: ..."

- 2.2 Moody's observes that issuers' disclosure of ratings in prospectus documents may be a superfluous requirement for three primary reasons.
- 2.3 Firstly, under current industry practices of the major rating agencies, ratings are already publicly disseminated and freely available. It is Moody's' policy to ensure that our public ratings are distributed via a press release, which discusses our reasoning for the rating action. This public communication is picked up by the major news wires and thus broadly circulated. The press release is then maintained on our web-site for the following

⁴ Common Position adopted by the Council on 19 July 2002 (REV6).

⁵ Dated July 2002 ref: CESR/02.089b and amended by drafts circulated on 15 December and 18th December 2002.

three days, and the rating itself can be accessed by the public thereafter. Thus, the issuer's disclosure of that same rating in the prospectus will not provide the investor with additional value-added information to which he would not otherwise have had easy and unfettered access.

- 2.4 Secondly, pursuant to the Market Abuse Directive and CESR's advice thereto, our current understanding is that ratings are likely to be characterised as information that falls within its purview. As a direct result, issuers may already be obligated to disclose through officially recognised public channels their ratings and rating changes. A second requirement under the Prospectus Directive to disclose the same information, therefore, would be redundant.
- 2.5 Thirdly, and as we will discuss in greater detail below, neither the Directive nor the Consultation Paper have clearly defined the issuer's obligation to reflect changes in the issuer's prospectus document. Therefore, should a rating agency publicly announce a change in its rating opinion, it remains unclear whether and to what extent that change will be reflected in the prospectus.
- 2.6 As ratings are real-time opinions, while the information in prospectus documents is refreshed only periodically, it is inevitable that issuers' prospectus disclosure of ratings will occasionally be "stale" and may have the unintended consequence of either misleading or confusing investors. Put simply, the investor will need to decide which rating to view as the more reliable assessment of present circumstances, the rating found in the prospectus or the one available in the public domain.
- 2.7 For the above reasons, we would submit that it is unnecessary for issuers to be required to disclose ratings in the prospectus document, and in some cases this requirement may result in out of date or misleading information being made available to investors.

3. The Appropriate Test For Disclosure

- 3.1 In the event CESR deems it necessary for issuers to disclose their ratings in the prospectus documents, Paragraph 259 next asks:

"...which of the following wording would be more appropriate:

- "Rating assigned to the issue of the securities by rating agencies and/or commercial bank lenders pointing out the name of the rating organisation whose rating is disclosed and explaining the meaning of the rating. If a rating does not exist, to the knowledge of the issuer, it is required to disclose the fact that there is no rating" or*
- "Rating assigned, at the issuer's request or with its co-operation, to the issue or to the securities by rating agencies and/or commercial bank lenders, pointing out the name of the rating organisation whose rating is disclosed and explaining the meaning of the rating"*

- 3.2 While we are supportive of CESR's efforts to mandate disclosure of relevant information, we believe that both proposed formulations are overly broad in terms of:

- 1) scope for the institutions whose ratings should be disclosed;
- 2) the factors which would necessitate disclosure; and
- 3) the content of the disclosure.

4. Institutions Whose Ratings Should be Disclosed

- 4.1 In the Consultation Paper, the two alternatives proposed by CESR for ratings disclosure identify "rating agencies" *and* "commercial banks" as institutions whose rating assignments must be disclosed.
- 4.2 We would submit that CESR consider confining the test to "rating agencies", thus limiting the issuer's disclosure requirement to the type of institutions whose credit assessments would be of significance to the general investing public. By way of example, we note that commercial banks may establish credit assessments that include certain aspects of credit ratings. However, they are typically developed for internal risk management purposes, often use symbols that are not widely understood by the general public, and may incorporate risk considerations unique to that commercial bank's security position or relationship with the issuer.
- 4.3 We further recommend that CESR define the term "rating agency" more specifically, as the term is overly broad and may unintentionally capture many different types of organisations. For instance, the phrase "rating agency", as drafted, could extend to trade credit reporting companies providing private credit assessments, or might encompass credit risk management services whose assessments are primarily formulated from statistical analysis of market data.
- 4.4 We suggest that CESR adopt of the following wording:

"RATING AGENCY will be defined, within the meaning of the Directive, as:

'an entity whose primary business is the issuance of credit ratings made broadly available to the general public for the purpose of evaluating the credit risk of debt securities.'

Such a formulation would alleviate the issuer's disclosure obligation with respect to credit services whose opinions are private or otherwise do not bear on the investment decisions of investors in debt securities.

5. Factors Which Would Necessitate Disclosure

- 5.1 Assuming that CESR restricts the types of institutions whose ratings would be subject to disclosure in the prospectus, Moody's would support CESR's adoption of a modified version of Paragraph 259's second formulation. Specifically, we suggest providing a second precondition, such as the rating's materiality, as a factor that would also trigger disclosure.
- 5.2 We believe that the first of the proposed formulations may impose a difficult duty on the issuer, while not necessarily increasing the information content of the disclosure obligation. It would compel the issuer to report the rating of every rating organisation that has produced a rating, and if a rating does not exist, *"the issuer is required to disclose the fact that there is no rating."* In effect, the issuer would be obliged to track rating agency activities and account for the existence, or not, of a rating, irrespective of the significance of that rating to the investor.
- 5.3 Paragraph 259's second formulation alleviates the issuer's obligation through conditioning the disclosure requirement of the issuer on a bright line test. The issuer is obliged to

- report the ratings of those agencies from which the issuer has either: a) requested a rating; or b) with which the issuer has co-operated. Moody's believes that this construction, if augmented with an additional test, is appropriate and would provide for the disclosure of relevant information.
- 5.4 Moody's recommends a materiality standard above and beyond the proposed "request" or "co-operate with" prerequisites. Specifically, CESR may explicitly require the issuer to disclose a rating opinion in its registration document if the bright line test has been satisfied – that is, the issuer "requested from or co-operated with" the rating agency – *or* the rating opinion satisfies CESR's advice with respect to the Market Abuse Directive as it pertains to direct information.⁶
- 5.5 Without this additional standard, the bright line test could have unintended ramifications. An issuer anticipating an unfavourable rating decision could avoid its disclosure requirement in its registration document by ceasing to communicate with that rating agency or to participate in the rating process. A rule that enables issuers to suppress their reporting of less favourable rating decisions seems contrary to the Commission's and CESR's ultimate objectives of market transparency and investor protection.⁷
- 5.6 We also note that where Moody's receives the co-operation of the issuer in the rating process, we are less likely to be surprised by developments and thus are at times better able to produce opinions that are less volatile and reactive.⁸ A standard that creates incentives not to co-operate with rating agencies, which the bright line test alone may do, will almost inevitably result in a more reactive rating system; one that would increase volatility and the likelihood of rating reversals.⁹ Such unnecessary volatility in ratings could increase the volatility of credit spreads and increase transaction costs for both issuers and investors in the European market, without providing a corresponding benefit.¹⁰

⁶ The rating is: 1) precise in nature; and, 2) has a price impact.

⁷ CESR could mitigate this risk to some degree by imposing a look-back rule. Such a rule would trigger the disclosure requirement if a rating decision were published by an agency to which the issuer had provided information during a stated time period (for example, 12 months) before the publication of that decision. However, we remain concerned that a look-back rule may simply delay the issuer's ability to avoid the disclosure requirement.

⁸ For example, in the event that a Moody's analyst is unaware of an issuer's strategy, he can only react as quickly as possible to information after it has become public.

⁹ Rating reversals are defined by Moody's as any rating change which is followed by a rating change in the opposite direction within a year. This occurs very infrequently at present. This is partly as a result of the ability of rating agencies to be informed of strategic decisions under consideration by the issuer (e.g. Remedial actions being planned to offset the negative credit impact of a debt funded acquisition). Issuers are highly motivated to avoid downgrades in the first place and therefore consider a reversal an indication that they have been subjected to an unnecessarily negative rating action. Investors are similarly intolerant of unnecessary rating reversals because of portfolio governance and performance measures that may result in the liquidation of an issuers' debt securities in the event of a downgrade. Investors wish to avoid liquidating holdings at a loss when the credit rating change proves temporary (e.g. forced sale at a loss when a bond is downgraded from investment grade to speculative grade – or Baa3 to Ba1 – only to have that bond shortly returned to investment grade status).

¹⁰ Investors who propose to purchase debt securities with a medium-term maturity will benefit most from a rating analysis which incorporates an assessment of the future strategy of an issuer and hence gives rise to a more stable rating.

- 5.7 It is Moody's opinion that the second formulation, if modified as mentioned in this and the previous sections, strikes the appropriate balance between disclosure of relevant information to the investor without imposing an undue burden upon the issuer. We suggest the following language for the first part of the formulation to replace both suggestions in Paragraph 259:

The following ratings should be disclosed in the prospectus, those:
“which are assigned to an issuer or its debt securities, (i) at the issuer’s request or with its co-operation in the rating process or (ii) which may have consequential impact on the issuer or its debt securities ...”

6. Content of Disclosure

- 6.1 Any disclosure requirements should result in information being clearly presented and should not have the unintended effect of either misleading the investor or giving rise to confusion. Yet, we suggest that necessity for a particular item of information to be disclosed in a registration document rests on two factors: 1) the materiality of the particular item of information; and 2) the ease of availability of that information, or better quality information, through other public media. Should the investor be easily able to access the same or better quality information through other means, it may make disclosure superfluous. If the information is otherwise unavailable, however, then disclosure could become consequential.
- 6.2 Paragraph 259 requires that the issuer disclose the "rating" assigned to its securities. Because rating agencies publish credit ratings, we would first recommend that CESR substitute the term "credit rating" for "rating".
- 6.3 Further, as rating agencies have numerous types of reports and research products it may be helpful to more clearly define the term "credit rating" and thus delineate the issuer's reporting obligation. For example, it is unclear whether the term "credit rating" would extend to other rating-like signals that speak to creditworthiness -- such as credit rating outlooks, and or changes in an issuer's credit watch or watchlist status.
- 6.4 CESR's exclusion of such additional signals would considerably reduce the disclosure burden on the issuer, especially if it holds ratings from multiple rating agencies. However, these signals convey information about an issuer's potential future creditworthiness. Their exclusion from prospectus disclosure rules would cause an investor to rely more heavily on other disclosure sources, such as those by the issuer as imposed by the Market Abuse Directive, or by the rating agencies through their public announcements.
- 6.5 As Moody's believes that rating-like signals, such as outlooks and watchlist status, may be of relevance to the investor,¹¹ we recommend that CESR consider whether to include in a definition for "credit rating" language that would also encompass these signals without simultaneously capturing other types of rating agency announcements or non-rating research publications. For example, CESR could adopt the following definition for the term credit rating, which would encompass rating-like signals concerning potential future creditworthiness:

¹¹ For a brief discussion of Moody's "outlooks" and "watchlist", please see Annex 1.

"Within the meaning of the Directive 'CREDIT RATING' is defined as:

'a publicly communicated opinion of a RATING AGENCY concerning the creditworthiness of a debt security or of an issuer of debt securities, provided that such opinion is expressed using an established and defined symbol system employing letters, numbers, alphanumeric symbols, or key words.'

- 6.6 We note that Article 9 of the Directive stipulates that a prospectus will be valid for a period of twelve months from its publication. Yet, as we have already indicated, if circumstances warrant, a rating action may be taken at any time, thereby rendering the information in the prospectus obsolete and potentially misleading.
- 6.7 To the extent that debt ratings are disclosed in the prospectus document, we believe that, in interest of full disclosure, the issuer should also communicate that the rating is current only as of the date of the prospectus' publication. Such a caveat will put the investor on notice that the rating may have since changed, and that for the most up-to-date rating he may consider either directly referring to the relevant rating agency or to the issuer's disclosure under the Market Abuse Directive.
- 6.8 Moreover, a rating is an opinion that speaks to the credit worthiness of a debt instrument of an issuer. It is not recommendation to buy, sell or hold a security. Thus, in the interest of investor protection, we request that CESR oblige issuers to make investors aware of this fact, and that the rating may be subject to revision, suspension or withdrawal at any stage.
- 6.9 The above two suggestions could help mitigate the potential confusion for investors. We would therefore advocate the following language:

"For the purposes of the Directive, the issuer is obliged to note prominently in the prospectus that with respect to CREDIT RATINGS:

- "the information contained in the prospectus is current as of the date of publication and neither the delivery of the document nor any sale made thereunder should, at any time, imply that the information contained therein is correct as of any subsequent date; and

-a CREDIT RATING is not a recommendation to buy, sell or hold securities and may be subject to revision, suspension or withdrawal by the RATING AGENCY at any time."

- 6.10 In addition, Paragraph 259, as worded, requires the issuer to "explain... the meaning of the rating". We request that CESR provide clarification on what is intended by the aforementioned phrase.
- 6.11 As the rating itself is a well used devise designed to summarise the meaning of the rating agency's opinion of creditworthiness in one easy to use symbol, and as Moody's has published several explanatory papers in relation to the meaning of our ratings and the

- process of our rating system management,¹² it appears that the rating agency - not the issuer - is in the best position to "explain the meaning of the rating".
- 6.12 Therefore, to require an issuer to give an explanation of the opinion of a rating agency would not necessarily provide meaningful information content to the investor as the issuer is not the entity originally responsible for formulating the meaning of the rating. Moreover, our papers, and explicit definitions for Moody's ratings, are publicly available on our web-site at www.moodys.com and www.moodyseurope.com. In the situation where the rating agency has published such papers, we would suggest that upon the initial issue of the prospectus, the issuer be permitted to simply refer the reader to the rating agency's web-site for the appropriate rating definition and explanation of the meaning of the rating, rather than attempt to interpret the rating for the agency.
- 6.13 What may be of relevance to investors, and what they would have no other means of accessing, is the issuing entity's analysis of the impact of a rating change (if any) on the debt security since the date of issue of the prospectus or the last update of the prospectus, as the case may be. Moody's submits that the investor may benefit more from an understanding of management's analysis of the impact of any recent changes in rating on the issuer rather than an interpretation of the "*meaning of the rating*".
- 6.14 For clarification, Moody's would further suggest that the term "debt securities" is used in the text rather than "securities", as securities opined on by rating agencies are debt instruments.
- 6.15 Therefore, as an alternative, Moody's suggests the following wording as a substitute for the two alternatives provided in Paragraph 259:

The following ratings should be disclosed in the prospectus:

"CREDIT RATINGS which are assigned to an issuer or its debt securities, (i) at the issuer's request or with its co-operation in the rating process, or (ii) which may have a consequential impact on the issuer or its debt securities, and which are publicly disseminated by the RATING AGENCY, pointing out the name of the rating organisation whose rating is disclosed and providing, to the extent that there has been a change in the credit rating since the publication or last update of the prospectus, an explanation of the impact of the change in rating on the debt security and/or the issuing entity."

7. Continuous Obligations to Update

- 7.1 Moody's is unclear as to the scope of the continuing disclosure obligations that will be imposed on the issuer and would request that CESR clarify its intent. We refer to Article 10 (1) of the Directive and Paragraph 283 of the Paper and note in particular the use of the terms "*at least annually*" and "*at least on an annual basis*" respectively. As the requirement to update the registration document was changed from an annual obligation, it remains uncertain as to when the issuer will be obliged to update its prospectus.
- 7.2 In particular, and as already discussed, we note that the Market Abuse Directive obliges the issuer to immediately disclose all information that may be material to the price of its securities. We would suggest that CESR is not seeking to impose an additional

¹² The most recent of which is "Understanding Moody's corporate bond ratings and rating process" 21 May 2002.

"immediate disclosure" obligation on the issuer in the form of a continuous update of its prospectus document.

- 7.3 However, in the event that CESR deems it fitting to impose a continuous updating obligation on issuers for their prospectuses, we would seek guidance as to the events that would trigger the disclosure. For example, should the issuer be obligated to update the prospectus when a rating agency changes or withdraws a credit rating, changes a credit rating outlook, or changes an issuer's watchlist status?
- 7.4 One approach is to clearly identify the triggering event that would require the issuer to bring up to date its registration document. For the purposes of Paragraph 259, we would suggest that a change of the issuer's or its securities' "credit rating", as defined above, may appropriately serve as the triggering event. Such a construction would exclude research products that provide an explanation of the credit rating but which should not give rise to a disclosure obligation on the part of the issuer.

8. Conclusion

- 8.1 Moody's commends the Commission and CESR in their efforts to improve the quality and timeliness of the disclosure of information to the market. To that end, we would advocate that should CESR intend to mandate disclosure of ratings, it define the parameters of the disclosure obligation more precisely.
- 8.2 By more clearly identifying the extent of the issuer's obligations, CESR will better position the issuer to disclose relevant information in the prospectus document. Such clarity will ease the administrative burden on the issuer and will ensure that the investor is provided with information that it requires or values in forming its investment decision.
- 8.3 We would be happy to discuss the contents of this submission paper and our views generally of the disclosure requirements of both the Directive and the any implementing guidelines with you, should you wish, at your convenience.

Yours sincerely,

/s/ Michael R. Foley

Michael R. Foley
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MOODY'S INVESTORS SERVICE LTD

Annex 1

Moody's and the Role of Rating Agencies in the Capital Market

1. Rating agencies provide independent and objective opinions about the creditworthiness of debt instruments and or issuers of debt instruments. Rating agencies assist debt investors to understand the credit aspects of the wider investment decision-making process. Their fundamental role, therefore, is to help increase the flow of information between issuers and investors, thereby lowering the costs associated with borrowing and assisting in overall market efficiency and transparency.
2. Moody's ratings are designed to provide a relative measure of credit risk, reflected by the probability of default by the issuer on its outstanding debt obligations and the consequent expected loss. The predictive content of Moody's ratings has been demonstrated over time by both Moody's and independent academic studies on the relationship between our ratings and actual default experience.
3. Moody's has nine primary long-term debt rating categories, ranging from Aaa to C. The lowest expected probability of default is at the Aaa level with a higher expected default rate at the Aa level, a higher expected default again at the single-A level and so on descending the rating scale. Moody's applies this long-term scale to ratings on other types of financial obligations and to companies. Moody's also assigns short-term ratings (primarily to issuers of commercial paper) on an independent rating scale that ranks obligations Prime-1, Prime-2 or Not Prime.
4. Moreover, non-rating signals, such as "Rating Outlooks" and the "Watchlist", have evolved to meet investors' needs for an indication of likely trends in future creditworthiness and the likely direction of our future rating actions.¹³ Rating Outlooks and the Watchlist allow us to signal our views without unnecessarily introducing volatility into the market.
5. Through our rating system management, therefore, we provide predictive opinions on one characteristic of a corporate entity's financial enterprise – its likelihood to repay its debt in a timely fashion. Investors are concerned with relative value based on their investment horizon, the particular terms and conditions of the debt, creditworthiness, pricing and

¹³ A Rating Outlook, expressed as positive, stable or negative, provides an opinion as to the likely direction of any medium-term rating actions, typically based on an 18-month horizon. If changing circumstances contradict the assumptions or data supporting the current rating, we will place the rating on the Watchlist under review. The Watchlist highlights issuers (or debt obligations) whose rating are formally on review for possible upgrade, downgrade or direction uncertain. At the conclusion of a review, typically within 90 days of placement on the Watchlist, we will determine whether the risks and expected loss are still consistent with the assigned rating. Although the Watchlist is not a guarantee or commitment to change ratings over a certain time horizon, or even to change them at all, historically, about 66% of all ratings have been changed in the same direction (and rarely in the opposite direction) as indicated by their Watchlist review.

- options. As such, our rating system offers but one element to investors in their decision making process.
6. Moody's ratings are determined through committees that decide on a majority-vote basis. The rating committee is typically comprised of the Managing Director; the analyst, who presents his or her recommendation and the reasoning supporting it; a backup analyst; junior support analysts; and may also include additional analysts who have expertise relevant to the rating decision.
 7. When a rating decision is taken by Moody's, the issuer is contacted and informed of Moody's imminent intent to publish that rating decision. As part of the process, Moody's provides the issuer with a copy of the draft press release announcing the rating decision. The draft press release will include the rating action and our reasoning for the rating action. The issuer then has a brief opportunity to review the draft press release to ensure that it does not contain any inaccurate or non-public information. The issuer may be dissatisfied with the rating outcome but the decision will be made public unless the issuer provides us with new material information.
 8. The press release, detailing any rating action, is available on our web-site for the following three days. After that, the ratings as well as the rating history can easily be accessed through our web-site.