To: ESMA

By e-mail to www.esma.europa.eu

STANDARD & POOR'S RATINGS SERVICES

RESPONSE TO ESMA CALL FOR EVIDENCE DATED 13 JANUARY 2011 ON THE CRITERIA FOR ENDORSEMENT (ARTICLE 21 (2) (a)) OF THE DRAFT AMENDED CRA REGULATION

Introduction

Standard & Poor's Ratings Services ("S&P") comments as follows on the Call for Evidence issued by the European Securities and Market Authority ("ESMA") on 13 January 2011 ("the Call for Evidence").

We support ESMA's goal of seeking to clarify aspects of the endorsement regime (as envisaged by the existing CRA Regulation) and reconsider the initial guidelines on endorsement where appropriate in light of new developments and experience.

Our main areas of concern regarding the application of the endorsement regime under Article 4(3) of the CRA Regulation have not changed materially since we made a public response to the original CESR consultation issued on 21 October 2009. This response – which focuses on the interpretation of elements of that endorsement regime - largely reiterates what we said at that time.

Our position remains that an interpretation of Article 4(3) – and in particular Article 4(3)(f) – which would require the equivalence of third country regulatory regimes for CRAs would contradict the clear words of the CRA Regulation and is wholly unnecessary in terms of ensuring that ESMA can supervise EU-registered CRAs to the requisite standard.

The "equivalence requirement" could also produce significant market disruption in that it could effectively prevent non-EU ratings being endorsed by EU-registered CRAs, and therefore prevent them being used by EU financial institutions. We trust that ESMA will, despite the short period of time allowed for the Call for Evidence, actively continue to request submissions from EU financial institutions on this point.

Equivalence and endorsement as envisaged in the CRA Regulation

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

The CRA 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 CRA Regulation, the endorsement mechanism requires only that the conduct of a CRA in a third country can be shown to fulfill requirements "*as stringent as*" those required of EU CRAs by the CRA Regulation. The wording of the CRA Regulation permits a third party CRA to follow such standards of conduct through its own policies and procedures.

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 CRA Regulation would not have adopted two differently worded tests.

The phrase "*as stringent as*" requires a focus on whether the quality assurance and controls surrounding a particular third country CRA are, as a matter of fact, functionally equivalent to those under the CRA 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 CRA Regulation.

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 CRA 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 CRA Regulation's endorsement and equivalence procedures.

We suggest that the CRA 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 CRA Regulation. We urge ESMA to confirm that these tests are separate and independent.

Importantly, the test in Article 4.3(b) of the CRA 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. <u>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.</u>

We suggest that a negative equivalence finding should not lead to a presumption against satisfaction of the requirements of Article 4.3 of the CRA Regulation, which is concerned with evaluating the conduct of specific third country 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 previously alluded to by the Commission and CESR 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 CRA Regulation.

We do not understand these concerns, and we do not see why they should lead to an intermingling of the "*as stringent as*" and "*equivalent to*" tests. Under the terms of the CRA

Regulation, endorsement is permitted if the third country CRA follows standards that are at least as stringent as those required under the CRA Regulation. The CRA Regulation does not require that those standards should be legally embedded in a third country's regulatory regime.

Recital 13 of the CRA regulation 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 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 CRA Regulation. It does not matter whether such compliance results from a third country regulatory system that legally embeds the requirements of the CRA 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 CRA 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 CRA Regulation in the EU, then Article 4.3(g) would be entirely 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, either informally or through arrangements arising out of memoranda of understanding, 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 CRA 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 CRA Regulation, because the Commission itself will have done that before issuing an equivalence decision (as per Article 5.1(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 that contained in Article 4.3(b) – simply whether the third country CRA observes standards as stringent as those required by the CRA Regulation, irrespective of whether such observance is mandatory under local regulatory requirements.

For those reasons, we reiterate that an attempt to interpret Article 4.3 as requiring equivalence of third country regulatory regimes would plainly contradict the clear words and clear intent of the CRA Regulation. It could also create market disruption by preventing non-EU ratings being endorsed by EU-registered CRAs and thus being used by EU financial institutions. This is not the intention of the CRA Regulation, and we urge ESMA to avoid this outcome by not confusing the distinct and separate tests for endorsement and for certification.

We would welcome additional guidance on this important topic but it must be consistent with the wording of the CRA Regulation itself, as we have explained above.