

# STANDARD & POOR'S

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Dear M Demarigny:

## **Response to Consultation Paper on Credit Rating Agencies**

Standard & Poor's Ratings Services ("Ratings Services")<sup>1</sup> welcomes this opportunity to respond to the consultation paper issued by the Committee of European Securities Regulators ("CESR") on 'CESR's technical advice to the European Commission on possible measures concerning credit rating agencies'.<sup>2</sup> We set out in this letter our general approach to the regulatory options highlighted in CESR's paper. The Annex to this letter sets out our detailed responses to CESR's questions.

### **Rating agencies should promote transparency by publishing own codes based on the IOSCO Code**

Ratings Services recognises that the more widespread use of credit ratings in the market and the increased reference to them in regulatory and contractual provisions raise a number of issues. However, Ratings Services believes that the primary response to these issues should not take the form of detailed regulation and, in particular, should not take the form of an authorisation (or registration) regime of the kind proposed for consideration by CESR.

Instead, Ratings Services believes that the best regulatory approach is one based on rating agencies themselves taking steps to ensure transparency - to the market, issuers and regulators - as to their methodologies and policies, with this non-legislative approach being underpinned by market forces, the enhanced role given to regulators to recognise rating agencies for the purposes of the proposed Capital Requirements Directive ("CRD") and the Basel II framework and the legislative measures already taken in the EU in the form of the Market Abuse Directive ("MAD").

This approach builds on the work of the International Organisation of Securities Commissions ("IOSCO") which published its Code of Conduct Fundamentals for Credit Rating Agencies in December 2004 (the "IOSCO Code")<sup>3</sup> calling on credit rating agencies to publish their own codes based on the IOSCO Code (and to explain any differences). Ratings Services already

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<sup>1</sup> More information on Ratings Services is available at <http://www.standardandpoors.com/>

<sup>2</sup> CESR/04-612b (November 2004), available at <http://www.cesr-eu.org/>.

<sup>3</sup> Available at <http://www.iosco.org/>.

published its own Code of Practices and Procedures (the "S&P Code") in September 2004 restating established policies and procedures relevant to its rating and surveillance processes<sup>4</sup> and expects to engage in further dialogue with the market, issuers and regulators to explain how these respond to the issues identified by the IOSCO Code. In any event, regulators should strive to ensure the greatest possible consistency of approach, both within the EU and internationally, building on IOSCO's work and avoiding unilateral regulatory initiatives.

### **Credit rating opinions have served international securities markets extremely well**

Ratings Services believes that credit rating opinions have served international securities markets extremely well, providing an effective, independent and objective tool in the market's evaluation and assessment of credit risk. Ratings Services believes that the availability of credible credit rating opinions has been a significant factor assisting the development of deeper, broader and more efficient and cost effective international debt securities markets.

Credit ratings are opinions, as of specific dates, of the creditworthiness of a particular company, security, or obligation. There is no one true ratings methodology, and no provably correct rating opinion. Accordingly, different rating agencies are likely to have differing rating opinions, and issuers and market participants will, and often do, disagree with a particular rating opinion. A credit rating is not investment advice. It is not a recommendation to anyone to purchase, sell or hold a particular security; nor does it comment on the suitability of an investment for a particular investor or group of investors.

Recent corporate failures have demonstrated the consequences for all market participants when companies fail to meet their disclosure obligations, or worse - set out systematically to defraud the market. Like other participants in the marketplace, Ratings Services was similarly misled by the issuers' disclosure failures. However, these events relate to a relatively small number of issuers, as compared with the many thousands of issuers which have been rated, and subject to ratings surveillance, over many decades. They do not indicate that there has been, in fact, any erosion in the independence, objectivity and integrity that have been the hallmarks of the principal international rating agencies.

### **Regulation should not prescribe methodologies or processes for credit rating agencies**

Ratings Services believes that regulation should not attempt to influence, directly or indirectly, the methodologies and processes used by rating agencies to arrive at their rating opinions. In particular, regulation should not attempt to prescribe methodologies or processes. Any such attempt is likely to be unsuccessful and counterproductive; it risks raising barriers to entry in the market, compromising the independence of rating agencies, stifling innovation and undermining the value to users of ratings opinions.

Instead, Ratings Services believes that the onus should be on rating agencies themselves to develop their own policies and make them available to the market, regulators and the general public. Ratings Services supports the general approach of the IOSCO Code which envisages that rating agencies will determine their own codes in the light of principles set by IOSCO.

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<sup>4</sup> Available at [http://www2.standardandpoors.com/spf/pdf/fixedincome/Code of PP 9-22-04.pdf](http://www2.standardandpoors.com/spf/pdf/fixedincome/Code%20of%20PP%209-22-04.pdf).

As already noted, Ratings Services has already published the S&P Code which restates established policies and procedures. The S&P Code makes clear that Ratings Services has policies designed to ensure, among other things:

- the independence of the rating process, both from external and internal, business-related influences;
- clear communication with issuers about the rating process and rating opinions, including an opportunity for issuers to object to rating opinions, where this is possible without interfering with the prompt communication to the market of rating opinions;
- significant disclosure to the market of rating procedures and methodologies;
- appropriate behaviour by individual rating staff members, in particular preventing market abuse and conflicts of interest.

#### **No need for additional legislation or regulatory initiatives**

However, Ratings Services does not believe that it will be necessary for there to be additional legislative or regulatory initiatives (either at the EU or national level) to underpin this approach.

First, market forces will themselves play an important role in ensuring that rating agencies live up to their published standards (as CESR accepts in its discussion of its option 6). A rating agency's failure to comply with those standards will undermine the credibility of its ratings opinions and its market position. As two Federal Reserve Board economists recently concluded after intensive study and analysis, Ratings Services and the other rating agencies consider their reputations in the marketplace to be of "paramount importance" and, in fact, are "motivated primarily by reputation-related incentives."<sup>5</sup>

Secondly, Ratings Services believes that the process for recognising rating agencies already embedded in the proposed CRD and the Basel II framework should, if properly structured and implemented, be capable of providing regulators with an appropriate opportunity to consider ratings agencies' actual practices against their own published standards. The Basel II criteria for recognition already include requirements as to the independence, objectivity, transparency, disclosure, resources and credibility of ratings agencies. There is no need to amend these to include new requirements or to introduce a parallel system of assessment (as would be necessary to implement CESR's option 3). It is unlikely that a rating agency that manifestly failed to comply with its own published policies would be able to meet the CRD's requirements (although we discuss below our concerns about aspects of the recognition process). In addition, the existence of this recognition process also addresses the desire of some smaller agencies for official recognition will assist their credibility in the market, although competent authorities will have to ensure that recognition is not viewed as endorsement.

Thirdly, the existing provisions of the MAD already appropriately address the key issues concerning the access of credit rating agencies to inside information and the risk that inside

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<sup>5</sup> See Daniel M. Covitz and Paul Harrison, 'Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate', The Federal Reserve Board Finance and Economics Discussion Series (December 2003), at 1, 3, available at [www.federalreserve.gov/pubs/feds/2003/200368/200368pap.pdf](http://www.federalreserve.gov/pubs/feds/2003/200368/200368pap.pdf).

information might be disseminated, disclosed or otherwise misused by credit rating agencies or their staff. This underpins credit rating agencies' own policies and procedures for the handling of confidential information and the approach taken in the IOSCO Code.

### **A non-legislative approach has many advantages**

Ratings Services believes that this non-legislative approach has many advantages:

- It should be relatively quick and simple to implement.
- It avoids some of the practical issues that would accompany any new legislative or regulatory initiative. For example, any new legislation or regulations of the kind envisaged in CESR's options 1, 2 or 5 would need to be able to define credit rating agencies in a satisfactory way, which is neither over-inclusive or under-inclusive. In particular, an authorisation (or registration) scheme, such as is envisaged in CESR's option 1 or 2, that applies to a broadly defined class of entities that express opinions on credit issues is likely to be over-inclusive (even if it is restricted to those that use defined ranking systems). In addition, it would be necessary to decide how any new rules should apply to businesses that operate across borders, which presents significant practical issues of definition and enforcement. This approach also avoids some of the risks presented by creating external arbitration or adjudication mechanisms of the kind envisaged by CESR's option 4, which were rejected in the course of the development of the IOSCO Code. Ratings Services believes that credit rating agencies should develop their own internal processes for ensuring compliance with their internal policies and procedures.
- It is less likely to give rise to unexpected or disproportionate implementation costs or unintended adverse consequences for the market or market participants. In particular, it avoids intrusive oversight or regulation of credit rating agencies that might appear to provide government or regulatory endorsement for individual rating opinions or to undermine the credibility and independence of credit rating agencies by subjecting them to direct governmental control. These risks are particularly acute with respect to an authorisation (or registration) scheme, as the market may perceive the risk that governmental or private issuers may seek to use the prospect of regulatory intervention to influence particular rating opinions or to dissuade credit rating agencies from particular rating actions. Thus, such a scheme could in fact damage, rather than enhance, investor protection and the integrity and stability of the financial system.
- It is likely to present fewer barriers to entry to new entrants, particularly those that might have different business models. The proposed authorisation (or registration) regime clearly envisages imposing a single set of rules on all those required to be authorised or registered, which excludes those that follow new or different approaches. The non-legislative approach avoids a "one size fits all" set of rules which may well have unintended consequences.
- It enables regulators to recognise the economic reality that major international rating agencies, such as Ratings Services, are integrated groups, even though they operate through a number of different legal entities. In particular, an authorisation (or registration) scheme will inevitably focus on authorising (registering) individual legal entities.

- It is likely to raise fewer issues as to the compatibility of the approach with the fundamental freedoms of expression guaranteed by the European Convention on Human Rights and the EU's commitments under the General Agreement on Trade in Services.
- It is also more flexible, as it is not tied to a particular legislative framework that might, over time, prove unsuitable and difficult to change. In addition, it reduces the risk of homogenisation of rating opinions or the behaviour of rating agencies through government mandated minimum or uniform requirements which might stifle innovation and creativity.

Furthermore, this approach accords with the recommendations made in the recent draft reports to the European Commission of the four independent groups of experts convened to consider the state of financial integration in the banking, insurance, securities and asset management sectors.<sup>6</sup> Among other things, these reports advocated that non-legislative solutions should be considered ahead of regulation and argued that new legislative measures should only be brought forward when impact assessments make a convincing case that the expected benefits to industry will outweigh adjustment or compliance costs.

Ratings Services believes that no such case has yet been made for new legislative or regulatory initiatives in this area. In particular, there is no evidence of a fundamental market failure of a kind that would justify the intrusive regulatory options considered in CESR's consultation paper, which are opposed by many key users of rating opinions (as indicated at CESR's public hearing).

Ratings Services believes that this non-legislative approach is the most likely to achieve consistency of approach with other international regulators. It builds on the work of IOSCO in this area and avoids new EU legislation which would go beyond internationally agreed standards.

It would also establish an appropriate parallel with the approach currently taken by the US Securities and Exchange Commission, which also rests on the recognition (rather than the authorisation) of rating agencies for regulatory capital purposes - as nationally recognized statistical rating organizations ("NRSROs"). However, if properly structured and implemented, it should not present significant new barriers to entry.

Nevertheless, it is not an approach which involves no further regulatory action at all. The implementation of the IOSCO Code, rating agencies' own codes, the CRD recognition process and the MAD all involve regulators to a much greater degree in this area of the market, which will involve a commitment of resources on their part.

### **Difficulties remain, especially with respect to the CRD recognition process**

In addition, the approach is not without difficulty. Ratings Services is concerned by aspects of the CRD/Basel II framework and the prospect of duplicative and disproportionately burdensome requests for information and intrusive oversight regimes, especially given the possibility of rating agencies having, in effect, to seek recognition in all 25 member states. However, Ratings Services believes that CESR and the Committee of European Banking Supervisors have important roles to play in co-ordinating the process.

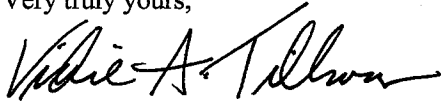
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<sup>6</sup> These reports are available at [http://europa.eu.int/comm/internal\\_market/en/finances/actionplan/stocktaking.htm](http://europa.eu.int/comm/internal_market/en/finances/actionplan/stocktaking.htm).

As mentioned above, see the Annex to this letter for our detailed responses to CESR's questions.

Ratings Services appreciates the opportunity to address the issues raised in CESR's consultation paper. Ratings Services would be pleased to answer any questions on this letter or the Annex if this would be helpful to CESR in preparing its advice to the European Commission.

Very truly yours,



Vickie A. Tillman



Francois Veverka  
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Institutional Affairs  
Standard & Poor's Europe

## **Annex**

### **Response to CESR's Questions**

In this Annex, we set out Ratings Services' responses to CESR's specific questions set out in the consultation paper (reproduced in *italics*). The questions are set out in the order in which they appear in CESR's consultation paper, following a brief discussion of market participants' use of credit rating opinions.

#### **BACKGROUND: MARKET PARTICIPANTS' USE OF CREDIT RATING OPINIONS**

Since beginning its credit rating activities in 1916, Ratings Services has issued rating opinions on more than two million securities issues, corporate and governmental and public finance issuers and structured financings. Ratings Services began its ratings activities with the issuance of credit rating opinions on corporate and governmental debt issues. Responding to market developments and needs, Ratings Services also assesses the credit quality of, and assigns credit ratings to, financial guarantees, bank loans, private placements, mortgage- and asset-backed securities and the ability of insurance companies to pay claims.

Today, Ratings Services has credit rating opinions outstanding on approximately 150,000 securities issues of obligors in more than 100 countries. Ratings Services issues credit rating opinions and monitors developments pertaining to these securities and obligors from operations in 19 countries around the world.

Ratings Services has been present in Europe for more than 20 years, currently employing 600 staff, including 300 credit analysts, in offices in Frankfurt, London, Madrid, Milan, Moscow, Paris and Stockholm. The staff in these offices play a crucial role throughout the rating process for European issuers, leading the initial credit analysis, in rating committees and in ongoing surveillance.

Ratings Services' credit rating opinions have achieved worldwide market recognition and acceptance - not only with issuers and investors, but also with bankers, financial intermediaries and securities traders - as efficient tools for differentiating credit quality. Underlying the credibility of Ratings Services' rating opinions is the market's recognition of the independence, integrity and objectivity of Ratings Services and the quality of its credit rating opinions.

On a daily basis, Ratings Services issues between 500 and 1,000 rating actions around the globe. These rating actions include initial ratings, rating changes, CreditWatch listings (which are used to signal to investors that further analysis is being performed and that a rating might be changed as a result of a specific event), Outlook changes (which represent Ratings Services' opinion as to the future direction of the rating, covering a six-month to two-year time horizon) and rating affirmations. It is through this daily process that Ratings Services' credit rating opinions are subject to constant market scrutiny. Ratings Services' focus is on furnishing rating opinions that will prove to be as credible and relevant as possible.

Over almost a century, Ratings Services' mission has remained the same - to provide high-quality, objective, rigorous analytical information to the marketplace. The track record of Ratings Services' credit rating opinions continues to be excellent, as demonstrated by studies on

rating trends and default and transition studies regularly published by Ratings Services. These studies have repeatedly shown that there is a clear correlation between ratings assigned by Ratings Services and the likelihood of default: the higher the rating, the lower the probability of default, and vice versa.

Nevertheless, credit ratings are opinions, as of specific dates, of the creditworthiness of a particular company, security or obligation. There is no one true ratings methodology, and no provably correct rating opinion. Accordingly, different rating agencies are likely to have differing rating opinions, and issuers and market participants will, and often do, disagree with a particular rating opinion. A credit rating is not investment advice. It is not a recommendation to anyone to purchase, sell or hold a particular security; nor does it comment on the suitability of an investment for a particular investor or group of investors.

Recent corporate failures have demonstrated the consequences for all market participants when companies fail to meet their disclosure obligations, or worse - set out systematically to defraud the market. Like other participants in the marketplace, Ratings Services was similarly misled by the issuers' disclosure failures.

For example, in his recent plea bargain agreement, the former chief financial officer of Enron stated that he and other members of Enron's senior management fraudulently manipulated Enron's publicly reported financial results with the aim of, among other things, fraudulently maintaining Enron's credit rating. Similarly, Enron's former assistant treasurer stated, in an attachment to his recent cooperation agreement, that, in communicating with representatives of rating agencies, he and others at Enron did not truthfully present Enron's financial position and cash flows and omitted to disclose facts necessary to make statements to rating agencies truthful and not misleading.

However, these events relate to a relatively small number of issuers, as compared with the many thousands of issuers that have been rated, and subject to ratings surveillance, over many decades. They do not indicate that there has been, in fact, any erosion in the independence, objectivity and integrity that have been the hallmarks of the principal international rating agencies. While there will be occasions when Ratings Services' ratings are scrutinised with the benefit of hindsight, including as a result of unforeseeable or simply unknowable events, Ratings Services' excellent track record demonstrates why its credit rating opinions are widely accepted as credible by the major users of credit rating opinions around the world.

## **DEFINITIONS**

*1. Do you agree with the definition of credit rating agencies? If not, please state your reasons.*

This question highlights the difficulty of arriving at a definition which can be used as a sound basis for a mandatory authorisation (or registration) scheme of the kind proposed for consideration by CESR.

CESR proposes a definition of a rating agency, based on IOSCO's October 2004 consultation paper on the IOSCO Code, which focuses on whether the primary business of a particular entity is the issuance of credit ratings. However, businesses providing information or opinions on credit related matters will have varying structures. For example, Ratings Services is not a separate legal entity but is part of Standard & Poor's which itself is a division of The McGraw



Hill Companies.<sup>7</sup> The McGraw Hill Companies and Standard & Poor's provide numerous products and services to customers all across the globe.

Other present and future providers of credit related information services will operate using differing legal entity structures, in which the issuance of credit ratings may or may not be the primary business of particular legal entities (and in any multinational group, the balance of business in the group's subsidiaries around the world will depend on the particular local circumstances, including tax and other requirements). Thus, it seems unlikely that the test proposed by CESR would form a sound basis for a mandatory authorisation (registration) scheme, as it would lead to differential treatment of entities carrying on similar businesses.

The final IOSCO Code adopts a broader definition which applies to any entity whose business it is to issue credit ratings, regardless of whether this is the entity's primary business. However, such a definition could prove over-inclusive if it were used as the basis of a mandatory authorisation (or registration) scheme, as it would catch any entity that provides opinions on the creditworthiness of issuers or their obligations, just because it uses a defined ranking system. As CESR's paper indicates, there is a huge variety of businesses that provide information and analysis on credit related issues (including elements of the financial and specialist trade press), many of whom could also use or adopt defined ranking systems. There is a risk that such a definition would produce unintended consequences if it were to form the basis of an authorisation scheme under which the defined class of entity were required to comply with a minimum set of requirements, even if based on the IOSCO Code, that might be wholly inappropriate to their business.

Similar issues to those described above would also arise if these definitions were used as the basis of legislation imposing rules of conduct on a defined class of credit rating agency.

As the Commission's proposals for the CRD indicate, there is less need for an explicit definition of ratings or rating agencies in a system in which regulators recognise ratings or rating agencies for particular regulatory purposes. Recognition schemes of this kind do not require a detailed definition.

*2. Do you agree with the definition of credit ratings? If not, please state your reasons.*

Ratings Services' credit ratings are current opinions as to creditworthiness and are not "forecasts". The final version of the IOSCO Code does not use the term "forecast" in its definition. We welcome CESR's reaffirmation that ratings are **not** recommendations.

*3. Do you agree with the definition of unsolicited ratings? If not, please state your reasons.*

We do not consider that the definition of unsolicited ratings should focus exclusively on the question of whether the credit rating is produced by the credit rating agency on its own initiative. It is also important to take into account, as in both the IOSCO Code and the S&P Code, whether the issuer participated in the rating process, although the two factors are closely connected.

The S&P Code envisages that Ratings Services may assign ratings without the full participation of issuers in the rating process, where it believes that there is a meaningful credit market or

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<sup>7</sup> For more information on The McGraw Hill Companies, please visit <http://www.mcgraw-hill.com/>.

investor interest served by the publication of such a rating and it has sufficient information to support adequate analysis and, if applicable, ongoing surveillance. In some cases, issuers may participate in the rating process to a limited extent and Ratings Services would still consider those ratings to be unsolicited ratings for the purposes of its policies and procedures. Ratings Services has policies for issuing unsolicited ratings in the local and regional markets and jurisdictions in which it operates.

*4. Do you think that issuers should disclose rating triggers included in private financial contracts?*

Ratings Services believes that issuers should disclose the existence of such triggers to credit rating agencies in the course of the rating process, so that the credit rating agency can consider the possible impact on the financial position of the issuer. Ratings Services routinely requests this information as part of the rating process.

In addition, in some cases, the nature or extent of an issuer's use of such triggers may be material for disclosure for investors, in which case issuers should publicly disclose them either in prospectuses or, in appropriate cases, ad hoc disclosures.

Ratings Services has, during the last few years, itself taken several initiatives to increase awareness about the effect of ratings triggers and similar provisions impacting expected financial flows in debt repayments (financial covenants) and expects to continue to do so in the future.

*5. Do you think that the use of ratings in European legislation should be encouraged beyond the proposed framework for capital requirements for banks and investment firms? If yes, please provide examples.*

While appropriate legislative and regulatory uses of credit ratings exist, Ratings Services does not seek the wider use of ratings in legislation or regulation. In general, it believes that it is preferable not to use ratings in legislation or regulation where the regulatory objectives can be met by some other technique.

## **COMPETITIVE DIMENSION: REGISTRATION AND BARRIERS TO ENTRY**

*1. Do you think there is a sufficiently level playing field between CRAs or do you think that any natural barriers exist in the market for credit ratings that need to be addressed?*

The existing market structure for credit rating agencies has developed in response to market forces and is primarily built upon the credibility that credit rating agencies, such as Ratings Services, have been able to establish over the years. This structure has served the market extremely well, as demonstrated by the general acceptance and increased usage of credit ratings on international capital markets and, in relation to Ratings Services, the clear correlation between the ratings assigned by Ratings Services and the likelihood of default shown by studies on rating trends and default and transition studies regularly published by Ratings Services.

The fact that it takes time to build a reputation and credibility does not imply a lack of diversity of opinion or mean that it is not possible for new entrants to establish themselves over time, particularly in specialist areas. In any event, a detailed and prescriptive regulatory regime would

be the most effective barrier to prevent access of new ratings services going forward, especially ones that might not adopt the business model of the leading international credit rating agencies.

*2. Do you believe that coverage of certain market segments or certain categories of economic entity (such as SMEs) may be sub optimal? Are there measures that regulators could use to effect this scenario? Which are they, and would it be appropriate to use them?*

Credit ratings are primarily linked with issuance on international public debt markets. Small and medium sized enterprises (SMEs) rarely access those markets and, accordingly, credit rating agencies such as Ratings Services have not generally covered many SMEs.

Nevertheless, the emergence, in Europe and elsewhere, of high-yield issuance and the development of securitization have broadened the range of enterprises with access to public financings and which require a credit rating. In addition, credit rating agencies such as Ratings Services have also started to develop specific tools for evaluating the credit of a broader range of enterprises, including SMEs, (generally using models) and for use by banks and other financial institutions with exposures to those enterprises. Nevertheless, the traditional rating service (where a credit rating agency issues a rating at the issuer's request) is likely to remain primarily targeted at entities well above the threshold of EUR 50,000,000 of revenues used by the European Commission for defining SMEs.

#### **RULES OF CONDUCT DIMENSION: INTERESTS AND CONFLICTS OF INTEREST**

*1. To what extent do you agree that in order to adequately address the risk that any conflicts of interest might adversely affect the credit rating it is sufficient to have the credit rating agency (i) introduce and disclose policies and procedures for management and disclosure of conflicts of interests, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?*

Ratings Services believes that the best regulatory approach is one based on rating agencies themselves taking steps to ensure transparency - to the market, issuers and regulators - as to their methodologies, policies and procedures, including their policies and procedures for managing and disclosing conflicts of interests. Credit rating agencies can only expect to continue to develop their business if market users - primarily investors - consider credit rating agencies to be credible and independent. However, in the recent debate in Europe about the impact of credit ratings, no serious case was made that issuers had excessive influence over rating agencies' decisions; conversely, the remarks of some issuers suggested that they would like to have a greater ability to influence and control the rating process.

As regards payments for credit ratings to credit rating agencies by rated issuers:

- Ratings Services currently discloses a range of fees received for each rating opinion it disseminates, in line with the IOSCO Code regarding such disclosure. Ratings Services believes that this practice provides the market with sufficient information and allows the market to evaluate the fees received by Ratings Services from issuers.
- In any event, Ratings Services rates such a large number of issuers that no one issuer is responsible for more than a very small portion of Ratings Services' revenue, certainly not enough to threaten Ratings Services' analytical independence.

- In addition, Ratings Services has other long-standing policies and procedures designed to ensure that the credit rating opinion on an issuer is not affected by the existence of or potential for a business relationship between it and the issuer. In particular, it has policies preventing analysts from participating in commercial discussions with issuers on fees. In addition, Ratings Services does not compensate or evaluate analysts based on the amount of revenues that Ratings Services derives from issuers that the analyst rates or with which the analyst regularly interacts.

Furthermore, other business units are separated from Ratings Services' activities and have absolutely no involvement in the ratings process. For example, firewalls and other appropriate measures are used to separate Ratings Services from the index, equity research, risk solutions, corporate value, funds and data services businesses of Standard & Poor's.

These principles have been reaffirmed in the S&P Code.

With respect to part (ii) of CESR's question, CESR seems to propose a system where, in effect, a credit rating agency would have to disclose a certification that a number of policies and procedures have been followed for each rating action. This raises a number of practical issues as to the processes that would be required to achieve this in the case of an international credit rating agency, such as Ratings Services, that issues, on a daily basis, very large numbers of rating actions. Such a requirement could delay the public release of rating actions which would be undesirable and, in our view, unnecessary. Similar issues arise with respect to questions 4, 5, 6 and 7 in this section, each of which envisages a specific disclosure accompanying each rating action.

*2. Do you consider that to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is necessary to prohibit a credit rating agency from carrying out those services? If your answer is yes, how would you address the entry barriers that could be created by imposing such a ban?*

Throughout its history, Ratings Services has dedicated itself to the principles of independence and objectivity. These principles have become Ratings Services' hallmarks and contribute greatly to the value of Ratings Services' rating opinions in the marketplace.

Ratings Services does not believe that there should be any substantial concerns about ancillary business activities. To Ratings Services' knowledge, there have been no findings of conflicts or abuse in the credit rating industry in general or specifically with respect to what some may consider rating agencies' ancillary business activities. Any attempt to prohibit the carrying on of ancillary business activities would be an overreaction.

There are many activities which pose no threat to the independence and objectivity of the analytical process and which might be described as "ancillary". Firewalls and other appropriate measures for safeguarding against conflicts of interest have worked well in the past and, in Ratings Services view, can and should provide an important check on potential problems.

Any proposal to prohibit ancillary business activities may also have unintended and unwarranted reach. Ratings Services is part of Standard & Poor's which itself is a division of The McGraw Hill Companies. The McGraw Hill Companies and Standard & Poor's provide numerous products and services to customers all across the globe. While these other businesses

are not ancillary to credit ratings in a technical sense, they could inappropriately and without justification be included in prohibitions against engaging in other activities. While some of the customers of other business units of The McGraw Hill Companies and Standard & Poor's are also issuers about whom Ratings Services issues ratings, those other business units are separated from Ratings Services' activities and have absolutely no involvement in the ratings process.

For these reasons, Ratings Services believes that the appropriate way to address any concerns that there may be regarding ancillary business activities is for rating agencies to have policies for the separation of their ratings businesses from other businesses that may present a conflict of interest. This is the approach adopted in the IOSCO Code. In contrast to the position concerning equity research, where regulators have had specific concerns largely based on evidence about the relationship with the firm's investment banking activities, it is difficult to identify any relationships that should be the subject of specific disclosures, while additional general disclosures are unlikely to be of real value to users of rating opinions.

Conversely, rating agencies are able to offer services to issuers that enable them to get a better understanding of alternative opportunities they may face in respect of the impact of these on their credit quality. These assessments, referred by Ratings Services as "Rating Evaluation Services" are **not** advisory or consulting services but genuine estimates of the consequence that any issuer pre-defined course of action may have for this issuer's rating. It is not a recommended course of action to achieve a better rating, and the issuer defines all underlying assumptions supporting the rating estimate with no interference with the rating agency. As a consequence, Ratings Services strongly believes that these estimates are part of the rating and surveillance process and do not represent different ("ancillary") services. We note that customers overwhelmingly support these scenario evaluations as part of the rating service.

In addition, Ratings Services considers that the services it provides of supporting its ratings with more detailed analysis and explanations are part of its core business and are not an "ancillary" service of providing "research".

*3. Do you think that structured finance ratings give rise to specific conflicts of interest that should be addressed in CESR's advice to the Commission?*

No. As CESR rightly points out, "the fundamental attributes of structured finance credit ratings ... are the same as those of corporate ratings". There may be a specific methodology for structured finance ratings which necessitates an ongoing interaction between the agency and the arrangers, originators or issuers of the transaction. However, the objective of the process remains the same - to provide an independent external evaluation of the creditworthiness of an issuer or its obligations. In any event, some issue-based corporate ratings may involve the same degree of interaction indicating that it is not possible to sharply differentiate this type of ratings from other rating activities.

*4. To what extent do you agree that in order to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce and disclose policies and measures managing and disclosing multiple business relationships with issuers in general and the issuer being rated in particular, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?*

See our comments in response to question 2 in this section.

In addition, with respect to part (ii) of the question, see our comments in response to question 1 in this section.

*5. To what extent do you agree that in order to adequately address the risk that an issuer paying for a credit rating might influence its rating it is sufficient to have the credit rating agency (i) introduce policies and procedures, including but not limited to the introduction of a fee scheme, (ii) disclose its fee scheme and (iii) disclose whether the fee scheme has been applied in each credit rating?*

See our comments in response to question 1 in this section. To summarize, credit rating agencies should have adequate policies and procedures to prevent undue influence from issuers and should disclose these policies and procedures.

Ratings Services currently discloses a range of fees received for each rating opinion it disseminates in line with the IOSCO Code. Ratings Services' fees are largely set out in fee schedules but in many cases have to be individually agreed to reflect the widely differing circumstances of each case. It would be overreaching, and would create barriers to entry, if CESR were to seek to require rating agencies only to operate on the basis of published tariffs.

*6. In order to deal with issues related to unsolicited ratings, to what extent do you agree that it is sufficient to have the credit rating agency (i) introduce and disclose policies and measures with regard to issuing unsolicited credit ratings and (ii) disclose when a particular rating has been unsolicited?*

See our comments in response to question 3 in the section headed "Definitions" above. Ratings Services agrees that it is sufficient for credit rating agencies to introduce and disclose policies and procedures with regard to issuing unsolicited credit rating ratings and to disclose information about individual ratings in accordance with those policies and procedures. In particular, Ratings Services considers that it is important that it can continue to assign ratings, without the participation of the issuer, where it believes that there is a meaningful credit market or investor interest served by the publication of such a rating and it has sufficient information to support adequate analysis and, if applicable, ongoing surveillance.

*7. To what extent do you agree that in order to adequately address the risk that any financial or other link between a credit rating agency and an issuer might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing financial links or other interests between a credit rating agency and issuers or its affiliates or investments in general and the issuer or its affiliates or investments being rated in particular, (ii) disclose the said policies and procedures and (iii) disclose whether the said policies and procedures have been applied in each credit rating?*

Issues regarding capital links with rated issuers are not, in practice, significant for Ratings Services. While Ratings Services is a part of Standard & Poor's which itself is a division of The McGraw Hill Companies, Inc., Ratings Services' business is separated from other businesses as described above.

However, with respect to part (iii) of the question, see our response to question 1 in this Section.

## **RULES OF CONDUCT DIMENSION: FAIR PRESENTATION**

*1. To what extent do you agree that in order to adequately address the risk that lack of sufficient or inappropriate skills might lead to poor quality credit ratings it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing levels of skills of staff, (ii) disclose the said policies and measures and (iii) disclose whether the said policies and measures have been applied in each credit rating?*

The quality of the ratings assigned by Ratings Services is best assessed through studies on rating trends and default and transition studies regularly published by Ratings Services. A credit rating agency producing low quality ratings would rapidly lose the credibility which is essential to its business.

The ratings assigned by Ratings Services are the result of complex interaction between Ratings Services methodologies, policies and procedures and the skills of its rating staff. Among other things, on-going training (through teamwork, exposure to diverse analytical credit situations and topical training, e.g. on accounting, financial analysis, risk management, etc.), practical experience through committee attendance and participation and review of rating criteria and performance through dedicated experienced analytical senior staff all contribute to high quality ratings. Initial formal qualifications of the analytical staff are ultimately only one aspect of this process.

Ratings Services believes that disclosing the individual qualifications of its analytical rating staff would not provide users of ratings with useful information enabling them to assess the quality of individual ratings. In addition, focussing on this particular aspect may in some cases be misleading. It must be kept in mind that ratings are the product of a committee vote and dialogue, and are not one person's opinion.

*2. Do you have any alternative approaches to address the actual or potential risk that lack of sufficient or inappropriate skills might lead to poor quality credit rating assessments?*

See our response to question 1 in this section.

*3. Do you think that undisclosed methodologies could lead to biased credit ratings or to biased interpretation of credit ratings?*

It is already Ratings Services' established policy, in line with the IOSCO Code, to publish extensive information about its procedures and methodologies so that outside parties can understand how Ratings Services arrives at a rating opinion. This includes information on the meaning of each rating category, the definition of default and the time horizon used when making a rating decision. Ratings Services also publishes extensive information on the criteria for rating particular types of issuers and transactions and it discloses the rationale for individual rating opinions in the accompanying releases. In addition, it publishes studies of historical default rates of rating categories so that interested parties can understand the historical performance of each category. These disclosures enhance the value of Ratings Services' rating opinions in the marketplace by demonstrating the credibility of the process applied and are a necessary underpinning enabling the establishment of ratings as a common benchmark.

*4. Do you see more advantages or disadvantages in the regulation of CRAs methodologies by securities regulators? Please describe the advantages and disadvantages that you consider and*

*which is the best way of dealing with them. Do you believe that this regulation would contribute in some ways to lead to common global standards for CRAs?*

Imposing regulatory criteria as to rating methodologies or processes or other operational, policy or rating requirements (such as criteria relating to the number or training of analysts) would be unhelpful and counter-productive. Such criteria cannot assure credible rating opinions and they risk erecting barriers to entry. They could have the unintended consequence of compromising the independence of a rating agency's analysis and could risk setting minimum or uniform standards of credit analysis.

This could erode the individual quality and independence of the rating agency's credit analysis, could stifle innovation in credit rating analytic technologies and may limit the availability of valuable credit analysis and information in the marketplace, to the detriment of investors and the transparency of the securities market. In such event, credit ratings no longer would represent the particularized opinion of the credit rating agency based on the rating agency's independent assessments.

Ratings methodologies, processes and policies are intertwined with the substance of the ratings opinion itself. The European Parliament's resolution on credit rating agencies<sup>8</sup> itself decisively rejected any attempts at regulatory intervention into the substance of ratings opinions or in the timing of publication of those opinions and stressed the need for total freedom of expression and for rating agencies' independence from political and business influence.

Regulating methodologies risks leading investors to believe that regulators have endorsed particular ratings and are responsible for them. The IOSCO Code does not seek to regulate rating methodologies and CESR should not seek to go beyond the IOSCO Code in this respect.

*5. Do you believe provisions of the IOSCO Code are sufficient, in terms of rules on CRAs' methodologies and the corresponding disclosure? Do you believe that CRAs should disclose to issuers changes in methodologies before starting to use new methodologies?*

Ratings Services is and always has been committed to providing the market with current information about its practices, procedures, processes, criteria and methodologies. Such transparency better enables market participants to utilize Ratings Services' rating opinions. Ratings Services publishes voluminous information about its practices, procedures, processes, criteria and methodology on Standard & Poor's free website [www.standardandpoors.com](http://www.standardandpoors.com) among other places. Ratings Services will continue to provide the market with robust disclosure about its practices, procedures, processes, criteria and methodologies. This approach is supported by the IOSCO Code which appropriately requires prompt disclosure of material changes to a credit rating agency's methodologies and its significant procedures, practices and processes. It also requires, where feasible and appropriate, disclosure of such material changes before they go into effect.

Any additional requirement that all such modifications be publicly disclosed prior to going into effect would not only be inconsistent with the nature of the ratings process but could also result in undue delay in the publication of rating opinions to the market. The processes, procedures

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<sup>8</sup> European Parliament resolution on Role and methods of rating agencies (2003/2081(INI)), Tuesday 10 February 2004 (P5\_TA(2004)0080), available at [www.europarl.eu.int](http://www.europarl.eu.int).



and methodologies utilized by Ratings Services arise out of Ratings Services' ratings experience. As particular rating opinions present new challenges that lead to new solutions, Ratings Services incorporates those solutions that have more general effect into its practices and policies.

Any system requiring across-the-board disclosure of all changes prior to adoption would have significant and undesirable practical consequences for the market as well. It would necessarily take time to evaluate each and every modification to determine if it requires disclosure and then to effect that disclosure clearly and effectively to the market. Because, as described above, modifications to policies, practices and methodologies often arise in the context of actual application to a particular rating opinion, disclosure of such modification prior to implementation would therefore require Ratings Services to hold off on issuing rating opinions until after proper evaluation and disclosure of methodological application in each case. In some situations, this could result in a corresponding delay on an issuer's ability to bring an issue to the market. In others, it could result in significant delays in the issuances of appropriate rating opinions. Either way, the results would be detrimental to the performance of the capital markets.<sup>9</sup>

We also agree with the IOSCO Code's approach of only requiring disclosure of material changes in methodologies and its significant procedures, practices and processes. This properly reflects the dynamic nature of the credit rating process. Depending on their nature, particular rating opinions may require slight modifications or adjustments to the general process which, while consistent with the overall nature of that process, could be considered "modifications" to that process as applied. In fact, Ratings Services as a matter of current practice often publishes substantial changes to criteria and methodology several months before they are implemented. However, to require it to disclose each and every variation as a "modification" to its general practices and procedures would risk confusing the market as to the essential elements of those practices and procedures. It would also place a tremendous burden on it and could result in a less dynamic rating process, all to the detriment of the market.

*6. Do you believe that regulation should concern all aspects of CRAs' methodologies? How appropriate is the choice of explicitly regulating the four proposed issues (disclosure and explanation of the key elements and assumptions of a rating, indication of some forms of risk warning, rules on updating of ratings and the inclusion of some market indicators within a rating opinion)? Would you deal with these issues by self-regulation?*

We strongly disagree with any proposal to regulate the methodologies of credit rating agencies, as this would undermine their analytical independence. See our response to question 4 in this section.

We believe that the IOSCO Code provides an adequate framework for the disclosure of significant information to the market concerning credit rating opinions. We do not believe that it is necessary to adopt further statutory regulation in the absence of any evidence that this approach has failed or of some other market failure.

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<sup>9</sup> Another concern is that issuers might be understandably reluctant to discuss with CRAs new, innovative structures if the CRA would have to publish its ratings approach to those structures in advance of any rating opinion. In such circumstances, issuers might fear that competitors would have an opportunity to obtain and copy their ideas before their implementation.

We do not consider that it would be appropriate or helpful for ratings to include a risk warning or sensitivity analysis. Indeed, such statements might well be misleading as they may suggest that the credit rating agency has made a series of hypothetical rating assessments based on different scenarios.

We also do not consider that it would be appropriate or helpful to require ratings to include market indicators. Users of ratings are able to determine what market data they should use to compare credit ratings. Credit rating agencies should not be required to endorse or adopt particular market measures of creditworthiness. It is for the market to determine what additional data would be helpful to use in conjunction with credit rating opinions.

## **RULES OF CONDUCT DIMENSION: RELATIONSHIP BETWEEN ISSUERS AND RATING AGENCIES**

*1. Do you consider that the combination of the requirements of the Market Abuse Directive in this area and the requirements of the current version of the IOSCO Code adequately address the issue of access to inside information by CRAs?*

Yes.

Ratings Services believes that it is essential that a rating agency can receive complete and accurate information as part of the credit rating process. It is helpful that the Market Abuse Directive makes clear that issuers can have an open dialogue with rating agencies, including disclosure of non-public price-sensitive information on a confidential basis, although the issuer will, in most cases, also be required to disclose this information immediately to the market, subject to the exceptions stated in the MAD. The MAD also rightly makes clear that credit rating agencies are different from (for example) research analysts, in that ratings are not recommendations to buy or sell securities.

Rating analysts are subject to the provisions of the MAD if they misuse inside information e.g. by dealing on that information or improperly disclosing it to others. In addition, the IOSCO Code makes clear that credit rating agencies should protect the confidential information they receive and regulate the personal dealings of analytical team members.

These requirements are adequate and any attempt to introduce additional regulations could adversely affect the ability of credit rating agencies to maintain an open dialogue with issuers and to continue to have access to issuer's confidential information. This could seriously undermine the quality of credit ratings and might mean that credit rating agencies have to perform European ratings differently from those completed in other jurisdictions.

*2. What is your view on requiring an issuer to itself disclose an imminent rating change where it has been advised of this by a CRA and where the rating announcement may itself amount to inside information in relation to the issuers' financial instruments?*

Ratings Services typically limits the delays granted to issuers in case of rating changes to the shortest possible period, generally allowing however issuers to check the draft press release for factual information and decide on the possibility of appeal. In many cases, European issuers have asked for a minimum delay for managing this process.

If issuers were subject to a regulatory requirement immediately to disclose a rating change, credit rating agencies would have to change this process so that rating changes were disclosed immediately. This would be inconsistent with IOSCO recommendations in this regard (and would be inconsistent with giving issuers any time for appeal of a rating decision).

*3. Do you consider that the requirements of the Market Abuse Directive in this area sufficiently address the risks that inside information might be disseminated, disclosed, or otherwise misused?*

Yes.

In connection with the discussion in paragraphs 135 to 137 of CESR's paper, we would mention that Ratings Services makes its rating actions available to the wider public at the same time as they are made available to our many subscribers worldwide. Ratings Services makes these available to the wider public via its public website and through a wire feed to the news media as well as via electronic and print subscription services. Rating actions and a short explanation of the basis for the rating action remain on Ratings Services public website for a minimum of 24 hours.

Nevertheless, we disagree with the suggestion that information provided to subscribers should be regarded as not being public in the sense of the Directive, apparently simply because they pay a subscription fee (any more than information contained in a paid for newspaper or magazine). We also disagree with the suggestion that it is not in the normal course of a credit rating agency's business to provide information to its subscribers. These suggestions are overreaching and suggest that CESR wishes to restrict the freedom of publications to communicate information to their subscribers, simply because they express views that are authoritative and influential.

*4. Are there any other issues concerning access to inside information which CESR should consider from the perspective of establishing a level playing field between CRAs?*

Establishing a "level playing field" between credit rating agencies concerning access to inside information beyond the general requirements of the MAD is neither feasible nor desirable.

In particular, Ratings Services does not believe that it is necessary or desirable to adopt regulations compelling issuers to give the same information to different rating agencies. Where the issuer is participating in the rating process with two or more rating agencies, the rating agencies may have different methodologies with differing information requirements which may justify the provision of differing information. If there is any disparity in ratings between agencies, which cannot be explained by differences in methodology or the published analysis, this is likely to lead to an agency making follow up enquiries or users seeking additional information to understand the reason for the differences. Ratings Services reserves the right to withdraw its ratings if it considers that there has been inadequate disclosure.

On the other hand, regulation plays an important role in ensuring that issuers provide adequate transparency to the market generally. Ratings Services believes that the enhanced continuous disclosure obligations in the MAD, the implementation of International Financial Reporting Standards in the EU and the forthcoming requirements of the Prospectus and Transparency Obligations Directives should assist, overall, in providing more and better quality information to

the market. The effective implementation of these measures should assist in equalising the position of investors and, indirectly, assisting in the rating process.

*5. Are there any other issues concerning the Market Abuse Directive's provisions concerning inside information that you consider to be of relevance to CRAs and their activities which need to be considered?*

No.

*6. Do you consider that it would be helpful to have a dedicated regime governing CRAs and their access to inside information?*

No.

*7. Is this provision sufficient to ensure that issuers have an opportunity to discuss and understand the underlying basis for any rating decision? If not, what other measures do you consider should be introduced?*

Ratings Services believes that these issues are already adequately addressed by its established internal policies and procedures as restated in the S&P Code. These already envisage that Ratings Services will keep issuers informed of the ratings process and provide an appeal process for issuers against a rating decision, where circumstances allow, based on material new information or significant clarification or interpretation of existing information. They also allow the issuer to be given prior notice of the contents of a rating press release so that the issuer can correct factual errors or prevent the inadvertent release of confidential information.

*8. In addition to being able to discuss the basis for a rating, should an issuer have a "right of appeal" where they disagree with the CRA's opinion?*

See our response to question 7 in this section.

Appeals may be granted where circumstances permit and where the issuer provides material new information or a significant clarification or interpretation of existing information.

An appeal process should however not be a way to delay a decision that needs to be communicated to the markets as quickly as possible. Therefore the agency should be able, if the appeal resolution cannot be performed immediately, to inform the market of the pending review (by "Credit Watch" or equivalent). It must be underscored that the appeal process is not compatible with the mooted obligation on issuers to communicate any rating change immediately (see question 2 above).

*9. Do you consider the provisions of the current draft IOSCO Code and the Market Abuse Directive to be sufficient to ensure that information published by CRAs is accurate?*

Ratings are, in themselves, neither accurate nor inaccurate as they represent opinions. The information published as part of the supporting press release will either be publicly available information or information provided by issuers and the responsibility for the accuracy of that information generally will lie with the issuer. The S&P Code envisages that Ratings Services may provide issuers with draft copies of press releases to review their factual accuracy.

*10. Given the lack of specificity in the current draft IOSCO Code to maintain internal records for any particular time period, do you think more specific measures would be appropriate, requiring for example all the information received by a CRA to be kept, along with records supporting its credit opinions, for a minimum of 5 years?*

Ratings Services already typically retains relevant information supporting credit rating decisions for a long time period. The requirements may vary by country and there is no need for CESR to prescribe additional requirements.

*11. Do you consider that it would be appropriate to introduce measures requiring the establishment of a rating agency data room to ensure that all CRAs had access to the same information concerning a particular issuer?*

See our response to question 4 in this section.

## **REGULATORY OPTIONS CONCERNING REGISTRATION AND RULES OF CONDUCT FOR CREDIT RATING AGENCIES**

*1. Could you assess the policy options concerning the need for regulation or other measures, with particular reference to the practical implications for competition in the rating market and for the quality of ratings and of information to the market? In particular:*

- *A full registration/regulation regime based upon detailed criteria;*
- *A lighter registration/regulation regime essentially based upon the IOSCO Code;*
- *To assess compliance to IOSCO Code Fundamentals in a parallel process to CRD's recognition;*
- *A third party's certification or enforcement of the IOSCO Code;*
- *Relying upon rules covering only specific aspects of CRAs' activity;*
- *Monitoring the market developments.*

See the covering letter for Ratings Services' comments on the preferred way forward. We would mention the following additional comments with respect to some of the other alternatives.

*Options 1 and 2 - Authorisation/registration.* CESR's proposals for registration appear to envisage a scheme under which credit rating agencies would require regulatory authorisation to operate in Europe. It seems that credit rating agencies would have to meet specified criteria, which might be more or less detailed, in order to engage in rating activities in European markets. Rating agencies that did not meet those criteria would be excluded from the market. This is significantly more restrictive than the US system under which rating agencies can choose to apply for recognition as an NRSRO but are not obliged to do so. It poses particular issues for new entrants or those whose business model does not fit the criteria.

An authorisation scheme of this kind presents particular problems of extraterritorial application. Bodies based outside the EU may express credit opinions on obligations issued or guaranteed by issuers incorporated in the EU or by non-EU entities whose securities are admitted to trading on EU exchanges or traded over-the-counter in the EU, either with or without the participation of

those issuers in the process. Similarly, producers of credit related information may have subscribers or users of their services in the EU. As already noted, an authorisation scheme also requires a definition of a credit rating agency which is neither over- nor under-inclusive.

In addition, authorisation schemes of this kind overlap with the CRD's provisions on recognition, creating additional, duplicative requirements which would increase cost for no obvious benefit.

Furthermore, an authorisation (or registration) scheme directly subjects credit rating agencies to governmental control and thus threatens their credibility in the investor community. In particular, a fundamental attribute of the business of credit rating agencies is independence of judgment and management. Any authorisation or registration scheme is likely to include powers to revoke or cancel the authorisation or registration required to operate on European markets and may well include other powers, such as to investigate, require information or access to documents, impose fines or impose additional rules or requirements on credit rating agencies.

The market may perceive the risk that a government could seek to use regulatory powers against a credit rating agency to influence the ratings of governments, state-owned corporations and other influential issuers. In any event, there are clearly some issuers who would seek to influence a regulator to use its powers so as to dissuade credit rating agencies from rating downgrades or other rating actions in particular cases. There is a risk that such a scheme (like a regime for the licensing of the political or financial press) would chill freedom of expression and independent analysis and lead to self-censorship. Thus, such a scheme could in fact damage, rather than enhance, investor protection and the integrity and stability of the financial system.

*Option 3 - CRD recognition process.* As we have indicated, we consider that the CRD recognition process will provide valuable regulatory underpinning for a process which relies on the rating agencies' implementation of the IOSCO Code. It is not necessary to amend the CRD recognition criteria to achieve this objective. However, we have already noted in the covering letter our concerns with respect to some aspects of the process.

*Option 4 - Third party certification/enforcement.* Proposals for third party arbitration or adjudication of ratings were raised in IOSCO's consultation document on its Code and were rejected. They raised some fundamental issues about the extent to which issuers should be able to enforce the provisions of the IOSCO Code and the potential chilling effect of giving issuers contractual remedies of this kind. On the other hand, the IOSCO Code does envisage that credit rating agencies should establish a function within their organisation responsible for communicating with market participants and the public about any questions, concerns or complaints. We believe that credit rating agencies should develop their own internal processes for ensuring compliance with their internal policies and procedures.

*Option 5 - Rules of conduct.* There are similar issues to those described above in relation to the definitions and extraterritorial application of any specific rules of conduct. Regulatory powers to enforce mandatory rules of conduct also raise many of the same issues with regard to governmental controls over credit rating agencies discussed above in relation to options 1 and 2.

*2. Could you please indicate your preferred option and highlight pros and cons that you see with regard to each policy option?*

See our response to question 1 above and the covering letter.

*3. Do you think the IOSCO Code of Conduct is conducive to reducing or increasing competition?*

We believe that the IOSCO Code could have adverse effects on competition if it were applied in a rigid and inflexible way. For example, some of the requirements of the Code may be inappropriate or unduly burdensome for smaller rating agencies or new entrants, especially if they do not follow the same business model as the larger international rating agencies. If EU regulators applied the IOSCO Code as an inflexible strict rule, setting a uniform minimum set of requirements, this could severely restrict competition. Instead, regulators should apply the Code as enshrining high level principles which can be satisfied in other ways provided that there is disclosure.

*4. Are there any areas where any European rules of conduct should be extended beyond the IOSCO Code?*

No.

*5. To what extent is a joint treatment of rating agencies by banking and securities regulators desirable?*

It will be important for banking and securities regulators to work together in their consideration of rating agencies. First, under the CRD, both banking and securities regulators will have an interest in the quality of ratings used by banks and securities firms applying the standardised approaches. Secondly, although securities and banking regulators also have different issues and potential areas of concern, both will need to consider similar information about rating processes. Thirdly, it is in the interests of investors to minimise the cost burdens placed on rating agencies if they have to deal with multiple regulators, each asking different questions, since these costs are ultimately borne by investors.