THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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# CESR's technical advice to the European Commission on possible measures concerning credit rating agencies

## Consultation Paper

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# EXECUTIVE SUMMARY

## Background

1. The European Commission ("The Commission") published on 27 July 2004 a call to CESR for technical advice on possible measures concerning credit rating agencies ("CRAs"), requesting CESR's advice by 1 April 2005. The background to this initiative is described in the Commission's call for advice, which is attached as Annex A.

2. CESR set up a task force responsible for developing the advice to the Commission. The task force is chaired by Ms Ingrid Bonde, Director General of the Swedish Finansinspektionen and supported by Javier Ruiz del Pozo from the CESR secretariat. In addition, representatives from the Commission and from the Committee of European Banking Supervisors (CEBS), take part in the task force as observers.

3. Due to the tight timetable set by the Commission, it has not been feasible to set up a consultative working group to advise the task force. However, in order to have input from market participants at an early stage, a seminar on CRAs with market participants was organised at CESR's premises on 8 October 2004. The seminar was divided in two sessions, one devoted to CRAs and another one with issuers and users of ratings. The seminar provided the members of the task force a valuable input of the different interests at stake. In addition, the CESR Market Participants Consultative Panel held a discussion on credit rating agencies during its seventh meeting that took place on 10 November 2004.

4. The task force drafted a questionnaire and circulated it among CESR members on 22 September 2004 in order to obtain an accurate description of the current situation in the EU jurisdictions regarding the issues included in the Commission's call for technical advice. A summary of the responses to the questionnaire is attached as Annex D.

5. This questionnaire was mainly based on the one elaborated by IOSCO when preparing its report on the activities of credit rating agencies. The questionnaire produced by IOSCO was also delivered to four CRAs (Moody's Investors Service, Inc, Standard & Poor´s, Fitch, Inc. and Dominion Bond Rating Service Limited) with international operations. Answers provided to the IOSCO questionnaire by Moody's, S&P, Fitch and Dominion to certain questions, have been used in the analysis of the situation in Europe, to the extent that these CRAs operate in most EU jurisdictions and represent a high portion of the European rating market.

6. The task force will work in an open and transparent manner in accordance with CESR's agreed consultation practices (CESR/01-007c). Due consideration will be given to the responses received to this consultation paper and also a reasoned explanation addressing all major points raised will be published alongside the final advice for the Commission.

## Purpose

7. The purpose of this consultation document from CESR is to seek comments on the draft technical advice that CESR proposes to give to the Commission.

## Areas covered

8. The consultation paper divides the issues included in the Commission's mandate in two main areas. The first one covers the analysis of a possible registration system for CRAs in connection with the

barriers to entry to the ratings industry. CESR considered that these two issues are closely linked, as any procedure of recognition or registration could be perceived as an entry barrier to the market. This analysis takes into account two systems of recognition that have to be considered before adopting any policy option in this area: the United States "nationally recognized statistical rating organizations" ("NRSROs") and the "external credit assessment institutions" ("ECAIs") included in the Commission's proposal for a Capital Requirements Directive.

9. The second area deals with rules of conduct issues: conflicts of interest (such as advisory/ancillary services, payments to CRAs, capital links), fair presentation of credit ratings (such as skills of agencies' staff or methodologies used for building credit ratings) and some issues that arise when considering the relationship between issuers and CRAs, such as the management of inside information or a possible right of appeal to rating decisions.

10. Finally, the last section of the paper seeks views from market participants on a number of strategic policy options that might be relevant to consider when assessing how to best deal with the issues discussed in the two previous sections.

## Public consultation

11. Following receipt of the mandate from the Commission, CESR began its work on 28 July 2004 by launching a call for evidence for interested parties to submit comments by 27 August 2004. CESR received 30 submissions and these can be viewed on CESR's website (www.cesr-eu.org). A summary of the main issues raised by respondents is included in Annex B.

12. The public consultation on the present paper will close on 1 February 2005. Responses to the consultation should be sent via CESR's website (www.cesr-eu.org) under the section "Consultations".

13. As part of the consultation process on this paper, a public hearing will be held in Paris, at CESR premises, on 14 January 2005 (starting at 10:00). An agenda for the hearing will be available on the CESR website. Inscriptions to the open hearing can be made via the CESR website (www.cesr-eu.org) under the section "Hearings".

# INDEX

## I. INTRODUCTION

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## Objectives of CESR's advice

14. As the Commission states in its call for advice *"the aim of the call is for CESR to provide the Commission with technical analysis and advice relating to the identified questions in order for the Commission to assess the need, or not, for introducing European legislation or other solutions in this field".*

15. CESR understands that this is not a level two mandate such as those received for developing implementing measures of the Market Abuse or the Prospectus directives. This means that the objective of CESR's advice is not to produce the basis of a future legal text, but to reflect CESR's study of some key issues related to credit rating agencies and propose different options to the Commission.

16. Accordingly, as final advice CESR intends to deliver to the Commission an analytical study of the issues, that will consist of a description of the current situation, the different alternatives to handle the problems, if any, pros and cons of each option and the regulatory spectrum that the Commission should consider. Notwithstanding, CESR will not refrain from stating its preferred policy option, in case there is a clear consensus among its members.

17. As such, this consultation paper has been drafted in an open way, putting forward the different options for the issues included in the call for advice and asking market participants to express their views on the alternatives proposed.

## Global approach

18. In its call for technical advice the European Commission requests CESR to carry out its work in collaboration with CEBS and in contact with the SEC. In addition, the Commission requires CESR to take into account initiatives undertaken in other public fora, including IOSCO, and the Commission's draft proposal on the review of the capital requirements for banks and investment firms (Capital Requirements Directive, "CRD").

19. Moreover, the majority of the responses to the call for evidence and most of the views expressed in the seminar, point out that given the global nature of the markets in which the CRAs and the companies they rate operate, there is a need to ensure a common worldwide approach on this subject and, therefore, support a close co-ordination between the different regulators. These respondents consider that previous works, more specifically those developed by the SEC and by IOSCO, need to be taken into consideration by CESR when preparing its advice. Contact with CEBS is also encouraged.

20. CESR acknowledges that any initiative on rating agencies must follow this global perspective and, to this effect, the task force has contacted the following bodies:

- **CEBS** participates as an observer to the task force meetings and its contributions have been very helpful for the task force. One of the objectives of this co-operation is to avoid any gaps or duplications between CESR work and that of CEBS under the CRD.

- The US Securities and Exchange Commission **(SEC)** has showed its willingness to collaborate with CESR and have been very helpful in establishing a fluid dialogue in order to avoid conflicts of regulations.

- **IOSCO's** recent work on this area (the Report on the activities of CRAs including the Statement of principles and the Code of conduct fundamentals) has been one of the main inputs for this paper. Several members of the CESR task force are also members of the IOSCO task force that has developed the abovementioned documents.

## Timetable

21. CESR's timetable for preparing the technical advice is set out below.

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|---|---|
| 14 January 2005 | Open hearing |
| 27/28 January 2005 | CESR meeting: policy discussion |
| 1 February 2005 | Consultation closes |
| February 2005 – March 2005 | Task force to prepare the draft advice |
| 17 March 05 | CESR meeting: approval of the final advice |
| 1 April 05 | CESR delivers its advice to the European Commission |

22. According to this timetable, market participants will have the opportunity to make verbal comments to this consultation paper during the 14th January 2005 hearing and also written comments until 1 February 2005. Once the consultation has closed, the task force will assess all the reactions from the market and prepare the draft advice for the Commission during February and March 2005. The draft advice will be submitted for approval by the 17th March 2005 CESR meeting.

## Summary of main actions undertaken in relation to CRAs and relevant documents

23. Due to the growing importance of CRAs in financial markets and recent events in these markets, numerous public contributions have already been made on the topic.

24. In the annex to the call for advice attached as **Annex A**, the Commission provides an exhaustive summary of the main strands that have been, or are being, undertaken internationally on credit rating agencies. A brief summary of the main actions highlighted by the Commission, with the necessary updates, is provided below. All the following documents have been duly taken into consideration by the task force when producing the consultation paper.

### 1. European Parliament

**1.1 European Parliament Resolution on role and methods of rating agencies.**

On 10 February 2004, the European Parliament (EP) adopted a Resolution on the role and methods of rating agencies, following an own-initiative report from its Committee on Economic and Monetary Affairs (Rapporteur: MEP Katiforis).

**1.2 EP resolution on corporate governance and supervision of financial services – the Parmalat case.**

On 12 February 2004, the EP adopted a Resolution on corporate governance and supervision of financial services – the Parmalat case, following an own-initiative report.

## 2. International Organization of Securities Commissions (IOSCO)

2.1 **IOSCO's Report on the activities of credit rating agencies, including a 'Statement of Principles' (September 2003)**

The final section of this report consists of a Statement of Principles. This Statement of Principles covers the manner in which credit rating agencies activities should be conducted in order to reinforce the integrity of the rating process and to assist credit rating agencies in providing investors with informed and independent opinions.

2.2 **IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies (on consultation process)**

Following IOSCO's first initiative outlined above, some securities regulators and some rating agencies suggested that more specific and detailed guidance on how the principles laid down in the Statement of Principles should be implemented in practice would be useful.

Therefore, IOSCO decided to develop a Code of Conduct for credit rating agencies, irrespective of legal and regulatory structures that was published on IOSCO's website on 7 October, inviting interested parties to submit comments by 8 November, 2004. The Code is attached as Annex C to this consultation paper.

As stated in its preamble, the CRA Code of Conduct Fundamentals are designed to be a set of measures that should be included in some form or fashion in the codes of conduct of individual CRAs. As currently drafted, these measures are not intended to be rigid or formulistic: when incorporating these measures into their own codes of conduct, CRAs will be able to maintain a degree of flexibility to deal with the different legal and market circumstances in which they operate. However, it is envisioned that securities regulators may decide to incorporate the CRA Code of Conduct Fundamentals into their own regulatory oversight of CRAs, may decide to oversee compliance of the CRA Code of Conduct Fundamentals directly, may decide to provide for an outside arbitration body to enforce the CRA Code of Conduct Fundamentals, or may rely on market mechanisms to enforce compliance if an individual CRA's own code of conduct fails to adequately address the provisions outlined by the CRA Code of Conduct Fundamentals.

After the consultation process, a final version of the CRA Code of Conduct Fundamentals will be submitted to the IOSCO Technical Committee for approval. This is expected to take place around the beginning of December 2004.

## 3. United States Securities and Exchange Commission (SEC)

Since 1975, the SEC has relied on credit ratings from "market-recognised credible" rating agencies in order to distinguish between grades of creditworthiness in various regulations under the U.S. federal securities laws.

These credit rating agencies, known as "nationally recognized statistical rating organizations" or "NRSROs", are recognized as such by SEC staff based on, among other things, acceptance of a firm's credit ratings by predominant users of securities ratings. While eight firms have been recognized as NRSROs to date, consolidation has resulted in the following four NRSROs at present: Moody's Investors Service, Inc., Fitch, Inc., Standard & Poor's, a division of The McGraw-Hill Companies, Inc.; and Dominion Bond Rating Service Limited.

During the past thirty years, SEC staff have developed a number of objective criteria for assessing NRSRO status. Under current practice, the SEC staff reviews a credit rating agency's operations, position in the marketplace, and other specific factors to determine whether it should be considered an NRSRO.

The single most important factor in the Commission staff's assessment of NRSRO status is whether a credit rating agency is "nationally recognized" in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. The SEC staff also reviews the operational capability and reliability of each credit rating agency[1]. In view of the growing importance of credit ratings to investors and other market participants, and the influence credit ratings have on the securities markets, in recent years, the SEC and US Congress have reviewed a number of issues regarding credit rating agencies and, in particular, the subject of their regulatory oversight.

## 3.1 SEC Report on the role and function of credit rating agencies (January 2003)

Following the Enron collapse, the SEC submitted to Congress in January 2003 its report on the role and function of credit rating agencies in the operation of securities markets in response to the Congressional directive contained in Section 702 of the Sarbanes-Oxley Act of 2002.

The report was designed to address each of the topics identified in Section 702, including the role of credit rating agencies and their importance to the securities markets; impediments faced by credit rating agencies in performing that role; measures to improve information flow to the market from credit rating agencies; barriers to entry into the credit rating business; and conflicts of interest faced by credit rating agencies. The report addressed additional issues such as allegations of anti-competitive or unfair practices; the level of due diligence performed by credit rating agencies when taking rating actions; and the extent and manner of SEC oversight of credit rating agencies.

To assist the SEC in preparing its report under Section 702 of the Sarbanes-Oxley Act, the SEC held public hearings on November 15 and 21, 2002.[2] Panel participants represented various views, including those of the NRSROs, non-NRSRO credit rating agencies, broker-dealers, buy-side firms, issuers, and the academic community. Topics included the current role and functioning of credit rating agencies, information flow in the credit rating process, concerns regarding credit rating agencies (e.g., potential conflicts-of-interest), and the regulatory treatment of credit rating agencies (including concerns regarding potential barriers to entry).

## 3.2 SEC Concept Release on rating agencies and the use of credit ratings under the federal securities laws (June 2003)

On 4 June 2003, the SEC issued a Concept Release, submitted for public comments until 28 July 2003. This work was considered by the SEC as part of their review of the role of credit rating agencies in the operation of securities markets.

The SEC was seeking comment on several issues relating to credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes under U.S. federal securities law and, if so, the process of determining whose credit ratings should be used, as well as the level of oversight that should be applied to such credit rating agencies.

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[1] The SEC staff's assessment includes a review of: (1) The organizational structure of the credit rating agency; (2) the credit rating agency's financial resources (to determine, among other things, whether it is able to operate independently of economic pressures or control from the companies it rates); (3) the size and quality of the credit rating agency's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit); (4) the credit rating agency's independence from the companies it rates; (5) the credit rating agency's rating procedures (to determine whether it has systematic procedures designed to produce credible and reliable ratings); and (6) whether the credit rating agency has internal procedures to prevent the misuse of non public information and whether those procedures are followed.

[2] Full hearing transcripts are available on the SEC website at http://www.sec.gov/spotlight/ratingagency.htm

The underlying aim was to find the appropriate degree of regulatory oversight that should be applied to credit rating agencies: between completely ceasing use of the NRSRO designation and implementation of a much more pervasive regulatory regime for credit rating agencies.

Most of the 46 commenters responding to the SEC's 2003 concept release supported retention of the NRSRO concept; only four recommended that it be eliminated. Generally, commenters requested that the SEC clarify the current NRSRO recognition criteria and application process and also enhance the SEC staff's ability to ensure that a credit rating agency continues to meet the minimum standards that led to the NRSRO designation. The SEC staff have considered a number of approaches on how best to achieve the objectives recommended by commenters, and anticipate moving forward with an acceptable proposal in the near future.

## 4. Association française des Trésoriers d'Entreprise (AFTE) – Association of Corporate Treasurers (ACT) – Association for Financial Professionals (AFP)

### 4.1 Rating Agencies Survey by US AFP (November 2002)

In November 2002, the US Association of Financial Professionals, composed of 14 000 individual members working in the field of treasury and financial management, released a survey on rating agencies.

### 4.2 Code of Standard Practices for Participants in the Credit Rating Process (April 2004)

In April 2004, AFTE (from France), ACT (from the UK) and AFP (from the US) released an Exposure Draft of a "Code of Standard Practices for Participants in the Credit Rating Process". This draft was submitted for public comment until 30 June 2004.

The code includes recommendations addressed to regulators, credit rating agencies and debt issuers.

25. In addition to the abovementioned initiatives, and in line with the Commission's request to collaborate with CEBS in view of the Commission's draft proposal on the Capital Requirements Directive (CRD), CESR has also taken the following documents into account.

## 5. The Capital Requirements Directive

The draft Capital Requirements Directive provides for the use of external credit assessments in the determination of the risk weights (and consequential capital requirements) applied to a bank or investment firm's exposures. Only the use of assessments provided by recognised External Credit Assessment Institutions (ECAIs) will be acceptable to the Competent Authorities ("CAs"). A recognition mechanism is therefore outlined in the draft Directive. This regime is based on the agreement by the Basel Committee on Banking Supervision of the so-called Basel II Accord.

### 5.1 Methodology

The CRD sets out a number of technical factors that should be taken into account when granting recognition. These criteria have their origins in broader, international agreements (particularly the abovementioned Basel Accord).

*Objectivity*: CAs are required to verify that the methodology for assigning credit assessments is rigorous, systematic, continuous and subject to validation based on historical experience.

*Independence*: CAs are required to verify that the methodology is free from external political influences or constraints, and from economic pressures that may influence the credit assessment taking into account factors such as:

- ownership and organisation structure;
- financial resources;
- staffing and expertise; and
- corporate governance.

*Ongoing review:* CAs are required to verify that credit assessments are subject to ongoing review, will be responsive to changes in financial conditions and comply with standards such as:

- back testing is established for at least a year;
- the regularity of the review process can be monitored by the CA;
- the CAs are able to require an ECAI to inform them of the extent of its contacts with the senior management of the entities it rates; and
- the CAs will be promptly informed of any material changes to the ECAI rating methodology.

*Transparency and disclosure*: CAs are required to ensure that the principles of the methodology utilised by the ECAI in the formulation of its credit assessments is publicly available so as to allow users to decide whether such assessments are derived in a reasonable way.

### 5.2 Individual Credit Assessments

*Credibility and market acceptance*: CAs are required to verify that individual credit assessments are recognised in the market as credible and reliable by the users of such credit assessments taking into account factors such as:

- market share of the ECAI;
- revenues generated by the ECAI and its financial resources; and
- whether there is any pricing on the basis of the rating.

*Transparency and disclosure*: CAs are obliged to verify that individual credit assessments are accessible at equivalent terms at least to all parties having a legitimate interest in these individual credit assessments.

### 5.3 Convergence on recognition standards in 5.1 and 5.2

CESR takes notes that CEBS is working on the convergence of the specific issue of the use by credit institutions and investment firms of external credit assessments for the purpose of determining the risk weighting of an exposure which is needed to calculate the amount of capital to set aside to cover the credit risk. According to the CRD, credit institutions and investment firms may use the external credit assessments of an ECAI to determine risk weightings only if the ECAI has been recognised as 'eligible' by the competent authorities. This recognition can only be granted if the ECAI is judged to meet the requirements laid down in the CRD.

## Definitions

### *Credit rating agencies*

26. The IOSCO Code of Fundamentals for CRAs defines credit rating agencies as

- those entities whose primary business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers or debt and debt-like securities; or

- any organization whose ratings are recognized for regulatory purposes by a financial regulatory authority.

27. CESR considered whether it would be appropriate to use the IOSCO definition for the purposes of its work and came to the conclusion that the second part of the definition could encompass entities that might be beyond the scope of this consultation paper.

28. CESR's task force carried out its research and developed the proposals set out in this paper having in mind as the subject of the work only those entities whose main business is the issuance of ratings of debt securities and issuers. The second part of the IOSCO definition would also include other institutions of a different nature to which the proposals set out in the consultation paper might not be suitable.

29. Credit ratings issued by CRAs are only one source available to market participants about credit quality. There is a huge variety of entities in the sell-side business such as investment banks and broker-dealers that provide information and analysis relevant to the debt markets and its participants, for example analysis provided to the market or to qualified operators on the creditworthiness of an issuer or an issue, on the occasion of a securities issue. In addition, most buy-side firms, such as mutual funds, pension funds and insurance companies conduct their own credit analysis for internal risk management purposes. These types of research and analysis would be excluded from the scope of this consultation paper.

30. The Market Abuse Directive and its implementing measures, in particular Directive 2003/125, address the fair presentation of investment recommendations and the disclosure of conflicts of interest. Recital 10 of this Directive clearly states that credit ratings issued by CRAs do not constitute a recommendation within the meaning of the Directive.

31. The task force also has taken into account the notion of External Credit Assessment Institutions (ECAIs) introduced by the CRD proposal of the European Commission. The Commission proposal does not explicitly define an ECAI. However, it is clear from Article 80(1) that an ECAI is an entity, other than an Export Credit Agency, that issues credit assessments (see description above of the Commission's proposal for a Capital Requirements Directive). Credit assessments are not defined by the Commission's proposal.

32. Article 81(1) states that an external credit assessment may be used to determine the risk weight of an exposure in accordance with Article 80 only if the ECAI which provides it has been recognized as eligible for those purposes by the competent authorities (eligible ECAIs). Competent authorities can determine that an ECAI is an eligible ECAI when it meets the Commission proposal's ECAI recognition principles in respect of methodology and individual credit ratings.

33. One of the principles that competent authorities have to verify according to the Commission's proposal is "credibility and market acceptance". They shall verify that ECAIs' individual credit assessments are recognised in the market as credible and reliable by the users of such credit assessments.

34. CESR analyzed whether it should be appropriate to consider as CRAs only those entities that meet the Commission's criteria for eligible ECAIs. It became apparent that this approach would have an impact on some of the issues that are discussed in this consultation paper, such as registration of CRAs and the entry barriers to the ratings industry. If CESR considered as CRAs only those entities that have gained market recognition, this would affect the competition issues that are being addressed by this paper.

35. Also, CESR has considered the different stages of both initiatives: the CRD proposal and the Commission's call for advice to CESR. Even though the CRD proposal is based on the new Basel accord, and therefore it seems unlikely that its key features would be modified during the legislative process, it is also clear that the way it is implemented will be very important in assessing its real impact on the way CRAs operate, if they wish to qualify as eligible ECAIs. Without prejudice at this stage to the final outcome of both initiatives, CESR believes that the subjection to two sets of duplicative requirements of a CRA who is also an eligible ECAI should be avoided. The avoidance of duplication will be better assessed at the end of the process, once CESR has carried out its analysis of the issues put forward by the Commission. To this effect CESR and CEBS are collaborating to identify where areas of potential overlap might be.

36. For the reasons above, CESR decided at this stage to consult on the basis of an approach broader than the eligible ECAIs concept but narrower than the IOSCO definition. CESR would propose a definition of CRAs that would take only the first part of the IOSCO Code of Conduct Fundamentals for CRAs.

37. Therefore, the term credit rating agency will have the following meaning when used in this consultation paper: **those entities whose primary business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers or debt and debt-like securities**. The term "debt and debt-like securities" is used to refer to debt securities, preferred shares, and other financial obligations of this sort that CRAs rate.

*Credit rating*

38. CESR proposes to follow the IOSCO definition of a credit rating as included in its CRA Code of Fundamentals. Therefore the term credit rating will have the following meaning when used in this consultation paper: **an opinion forecasting the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system. Credit ratings are not recommendations to purchase or sell any security.**

39. CESR believes that this approach, which considers credit ratings as opinions, by no means should be understood as a way of diminishing the importance of ratings for securities markets. The word "opinion" when referring to credit ratings has been chosen not only by IOSCO but also by the Commission (recital 10 of the Commission Directive 2003/125 implementing Directive 2003/6 (the Market Abuse Directive). The definition proposed above would therefore have the advantage of ensuring consistency with the IOSCO Code of Fundamentals and with the Market Abuse Directive.

*Unsolicited Rating*

40. The term unsolicited ratings is used in this paper from different perspectives. Many entrants to the ratings industry issue unsolicited ratings as a way to gain credibility in the market. It is therefore a question linked to the entry barriers discussion. Also, as unsolicited ratings might be based only on public information, questions arise such as the need to disclose this fact.

41. CESR considers that the key factor to define unsolicited ratings is to know who takes the initiative. Solicited ratings would be those where the initiative has been taken by the issuer. Otherwise the rating would be unsolicited. CESR thinks that the term unsolicited rating does not equate automatically to a rating produced without co-operation from the issuer. There is a spectrum of possibilities ranging from no contact between the CRA and the issuer and full co-operation. This is discussed in the relevant section of this paper.

42. Also, CESR thinks that the concept of the initiative is more appropriate than the payment, as issuers might end up paying for ratings that they did not solicited in the first place. Therefore, CESR proposes to define an unsolicited rating as **a credit rating produced by a credit rating agency on its own initiative.**

***SME***

43. For the purposes of this consultation paper, **small and medium-sized enterprises means companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding EUR 43,000,000 and an annual net turnover not exceeding EUR 50,000,000.**

44. This definition is taken from the SME definition provided by Directive 2003/71 on the prospectus to be published when securities are offered to the public or admitted to trading (the Prospectus Directive) which in turn is based on the Commission Recommendation of 6 May 2003, concerning the definition of micro, small and medium sized enterprises.

## Use of ratings in private contracts in Europe

45. Item 3.5 in the Commission's call for technical advice, requires CESR to analyze whether there are issues relating to the use of ratings in private contracts.

46. Plenty of literature has already been produced in relation to this subject. In particular, several studies have been undertaken in relation to the use of ratings in private contracts at an international level and the negative consequences of this use.

47. With the aim of providing a comprehensive outlook of the main issues relating to the use of ratings in private contracts, CESR has compiled in **Annex E**, some of the relevant analyses produced in this area. A brief introduction of the purpose, together with a summary of the conclusions that can be drawn from the study and extract of the main paragraphs dealing with the subject, when possible, has been provided for each document.

48. As a basic summary of the above mentioned studies, three conclusions need to be highlighted:

- CRA ratings are frequently used in private contracts for a variety of purposes, the most recurrent use being the inclusion of "rating triggers" in financial contracts. Rating triggers are contractual provisions that give counterparties and lenders the right to terminate the credit availability, accelerate credit obligations, or have the borrower post collateral, in the event of specified rating actions, such as if the rating of the borrower's fixed-income securities falls below a certain level. These provisions are sometimes required by counterparties in order to help them secure collateral and recover prospective losses in cases where a borrower faces a serious likelihood of bankruptcy or default.

- Not all rating triggers are alike. Some are relatively harmless, such as those that incrementally increase the interest paid on loans and bonds in line with rating downgrades. However, some might have significant potential negative impact on the issuer. In this case, contractual rating triggers can seriously escalate liquidity problems at firms faced with a deteriorating financial outlook. For instance, when investors are entitled to sell their bonds back to an issuer immediately following a downgrade, which results in a funding crisis just when a firm is least able to deal with it.

- Disclosure of rating triggers by issuers has until recently been incomplete and largely ignored by analysts and investors. Transparency and disclosure are important features that could help mitigate some of the negative aspects of rating triggers.

49. In addition, CESR has gathered information more specifically on the use of credit ratings in private contracts in the different EU jurisdictions through the questionnaire distributed among its members. The evidence gathered from the CESR questionnaire is consistent with the conclusions that can be drawn up from the above mentioned studies and also with the contributions from the CRAs to the IOSCO survey.

50. The importance of disclosing the use of ratings in private contracts and in particular rating triggers has already been pin pointed in the European Parliament (EP) resolution on role and methods of rating agencies. The EP *"considers it an obligation of ratings users, whether in the private or in the public domain, to use ratings with proper regard for the stability of financial markets, especially by disclosing any rating triggers included in loan agreements or face the sanction of such clauses being declared null and void".*

51. It is also relevant to consider the Commission's Regulation N° 809/2004 implementing the Directive 2003/71 on the prospectus to be published when securities are offered to the public or admitted to trading. The Regulation sets out in its annexes the disclosure requirements for prospectuses. Among these annexes, the schedule setting the minimum disclosure requirements for the Share Registration Document requires issuers to provide, among other, the following information:

    - Information concerning the issuer's capital resources (both short and long term);

    - Information on the borrowing requirements and funding structure of the issuer;

    - Information regarding any restrictions on the use of capital resources that have materially affected, or could materially affect, directly or indirectly, the issuer's operations.

52. This provision could be understood as requiring the disclosure of material rating triggers. In that respect, the consultation paper CESR/04-225b on prospectuses proposes to recommend the application of the abovementioned provision of the Commission's Regulation in the following way: *"where the issuer has entered into covenants with lenders which could have the effect of restricting the use of credit facilities, and negotiations with the lenders on the operation of these covenants are taking place or are expected to take place, this fact should be discussed. Where a breach of covenant has occurred or is expected to occur, the prospectus should give details of the measures taken or proposed to remedy the situation."*

53. According to this recommendation, rating triggers that can be understood as covered by the notion of "covenants" would be disclosed in the prospectus.

## Use of ratings in European legislation

54. Item 3.5 in the Commission's call for technical advice, requires CESR to consider, from a technical point of view, whether further use of ratings in European legislation should be encouraged beyond the proposed framework for capital requirements for banks and investment firms.

55. CESR considers that this question can only be answered on a case-by-case basis. To this effect this consultation paper is seeking views from market participants on whether they can identify areas where the use of ratings could be encouraged. In any event, it would be necessary to identify all the alternatives capable of achieving the regulatory objectives sought by the use of ratings in the legislation. A detailed study of the strengths and weaknesses of each alternative, including the use of ratings, should be prepared prior to any conclusion.

56. In addition, as part of the analysis undertaken in relation to this issue, CESR included in its questionnaire a specific question relating to the use of ratings by financial regulatory authorities. The questionnaire responses indicated that financial regulators in many EU jurisdictions appear to use credit ratings for a variety of purposes. These uses vary from setting capital requirements for banks and other financial institutions to rules governing the investments of money markets funds and collective investment schemes, and in regulating public offers of asset-backed securities. Also, supervisors of insurance companies use ratings in different ways, such as for calculation of their technical reserves, to determine eligible counterparties or in the context of stress testing that insurance companies are obliged to apply.

Questions

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

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

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

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

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.

# II. COMPETITIVE DIMENSION: REGISTRATION AND BARRIERS TO ENTRY

This section covers two broad areas included in the Commission's call to CESR for technical advice. Item 3.4 of the call for advice requests technical advice related to the existence of possible entry barriers to the market for provision of credit ratings. In addition, item 3.6 requires CESR to consider whether CRAs should be registered in the EU and if so under what type of regime.

## Natural barriers to market entry or expansion

57. New CRAs face a number of natural barriers to entry and existing CRAs face a number of natural barriers to expansion. Examples for those barriers to entry might be the size and experience of CRAs, reliance on unsolicited ratings, resources and coverage, the start-up costs for new CRAs, any recognition criteria, the costs of ratings themselves and special business segments. The following analysis illustrates some of these barriers and is based upon information provided in the responses to the CESR questionnaire as well as the seminar organized by CESR on 08 October with CRAs and users of ratings.

### Possible advantage of size and experience of CRAs

58. The very nature of the CRA market might make it difficult for new CRAs to succeed. Issuers usually only desire ratings from those CRAs that are respected by investors. However, investors might tend to respect only those CRAs with a history of accurate and timely credit ratings. Investors could be reluctant to accord the ratings of a new entrant the same regard as those of established CRAs because new entrants lack historical default rates by which investors can compare performance to that of other CRAs. As a result, issuers may be reluctant to engage a new entrant for a rating. Without investor or issuer interest, it may take considerable time for a CRA's rating business to become self-sustaining.

### Additional requirements and challenges in relation to unsolicited ratings

59. As issuers initially may express no interest in contracting with a new entrant for a rating, new entrants might see one option to build their reputation on the basis of unsolicited ratings. In this case there might be, as explained in the definition of unsolicited ratings, no cooperation and input from the issuer itself. It may be more difficult to make an accurate assessment of credit risk without access to non-public information and without the option to seek clarification from the senior management of the issuer of any uncertainties. This last point, however, may be mitigated to some extent if ongoing issuer disclosure obligations provide sufficient and clear information to the public so that a new entrant can, through careful analysis, draw accurate and timely conclusions regarding the issuer's financial health and economic prospects.

60. Additionally investors may wish to have notice that a rating was unsolicited and/or what kind of information has influenced the rating in order to take this fact into account when making their investment decisions. As mentioned new entrants frequently rely on unsolicited ratings in order to build their reputations. Blanket prohibitions on the activity effectively may constitute a barrier to new entrants. The Statement of Principles of IOSCO already notes, that this issue may be addressed through disclosure and marking whether a rating is solicited or unsolicited.

### Possible lack of resources and coverage

61. A new entrant may have fewer resources (staff, analytical tools and other resources) and coverage than more established CRAs. Without these resources and coverage, a new entrant may be at a disadvantage vis-à-vis more established CRAs, who may be able to hire more staff (and more experienced staff) to analyze large issuers involved in numerous complicated transactions.

### Start-up costs for new CRAs

62. There might be high start-up costs that new entrants could face, therefore new CRAs may be perceived to be vulnerable to financial pressures that larger CRAs may be insulated against. To a new entrant, a single fee-paying issuer may comprise a large portion of the CRA's overall revenue, creating a potential barrier to entry as rating users might fear this significant revenue steam would influence rating decisions. Likewise, the large amount of capital and time necessary to establish a new entrant may necessitate an affiliation with a larger firm. Any such concerns could discourage the use of ratings issued by new CRAs.

### Government recognition criteria

63. Furthermore, some commentators have suggested that issuers may prefer to retain, and investors may prefer to use, the opinions of CRAs that a government regulator or agency also uses. Where government CRA recognition criteria are based on how extensively a CRA's opinions are used by issuers and investors, such a situation arguably may discriminate against new entrants, with regulatory recognition being based on reliance by the market, and market reliance being influenced by regulatory recognition.

### Mergers and reduction in the number of CRAs

64. New CRAs that do gain market share have historically tended to be taken over or merge with other CRAs, suggesting that there are economies of scale and scope in the production of ratings. This is likely to reduce the natural number of successful players in the CRA market.

### Costs of ratings

65. Some firms (particularly SMEs) might find a rating beneficial but the cost prohibitive. In particular, smaller firms like SMEs might not have the capacity to pay for a rating as the rating process might involve significant payments to the CRA. But smaller firms might look for external ratings more than in the past, since there is a trend towards the use of market financing for smaller as well as larger companies. Enhanced competition between CRAs may allow a reduction in the price of ratings. Economic analysis suggests that prices tend to be lower in a competitive, as opposed to oligopolistic, environment, but there is no real evidence of such phenomenon in the market for ratings. It is however potentially difficult to reduce the cost of providing a rating very far without reducing the degree of due diligence undertaken. This could limit the natural size of the market and therefore potentially the number of viable CRAs.

### Niches for smaller CRAs

66. This analysis set out above could provide an explanation for why the CRA market in the EU contains only a few significant players despite the current relatively light touch regulatory environment. However, it should be taken into account that smaller CRAs might have been able to successfully operate in niches that are too small for the major CRAs and therefore that it is possible to overcome, at least partially, these barriers.

## Registration and entry barriers

67. The potential need for registration and/or other regulatory measures at the European level concerning the credit rating industry is a very important issue. It could have a significant impact upon the trade-off between a high level of competition in the rating market, which implies not having too high barriers to entry, and the provision of ratings of adequate quality, based on the experience and expertise of CRAs. These factors could be very important particularly for new agencies, which are trying to enter or to develop within the rating market.

68. Analysis, at CESR level, of the possibility of introducing some regulatory provisions with regard to the European rating market, should start from the premise that in this field some relevant issues exist, which are not completely referable to the context of capital requirements of intermediaries. In fact, they concern the primary nature of ratings as a source of information – which could be defined as "derived information" because it is information elaborated by the CRA based upon the distillation of other information (especially with regard to the issuer's financial situation and conditions). CRAs act as providers of this derived information to the financial market. Therefore, in performing this activity, CRAs have to adopt proper conduct, respectful of rules of correctness and transparency.

69. The choice among different regulatory options has to take into account that tighter rules on one hand can contribute to improving the quality of ratings, but on the other hand can represent a source of barriers to entry into the rating's market. These barriers to entry might be increasingly higher when we consider different options, moving up the scale from self regulation to strict regulation. On the other hand, some market participants have argued that a registration system, together with a clear set of criteria that CRAs would have to fulfill in order to obtain recognition, could potentially have a positive effect on competition, as it would increase the visibility of the recognized small/new rating agencies

70. Moreover, it is important to consider the barriers to entry that could be originating from the regulation in force: these barriers do not seem to be very high in the current European regulatory framework, not characterised by the presence of stringent rules on rating. However, some barriers to entry could be likely to originate from the rules established by the proposed Capital Requirements Directive (CRD) as criteria for recognition and from those existing in the U.S., given the international nature of the big CRAs.

71. Concerning the proposed CRD, an inevitable consequence of defining recognition requirements is that some CRAs will not obtain recognition as an ECAI (External Credit Assessment Institution, the term that is used in the CRD). Consequently, the implementation of recognition has the potential in itself to create barriers to entry that do not currently exist. In addition, the fact that initial and on-going recognition will incur some level of compliance costs may also create a potential barrier to entry or expansion.

72. A key influence on the extent to which recognition may create barriers to entry will be the stringency with which Competent Authorities (CAs) choose to implement the recognition criteria outlined in the CRD. The more conservative the implementation of recognition requirements (in terms of volume of requirements, their stringency, and the inflexibility of CAs in assessing them), the higher the potential barriers to entry might be.

73. In addition to the possible barriers arising from the individual criteria that an ECAI should meet to obtain recognition under the CRD, barriers may be also created by the manner in which the CAs might operate the recognition regime. A recognition framework that was duplicated in all, or was materially inconsistent between, Member States could raise compliance costs. In this respect it is important to note that the CRD currently leaves it to individual CA's to determine:

- whether to undertake direct recognition or to minimise the addition of new barriers to competition by mutually recognising other CAs' recognition regimes;

- whether to take into account any non-EU recognition regimes an ECAI may already be subject to;

- whether to recognise ECAIs on a legal entity basis or at group level;

- precisely how to take into account the technical criteria set out in the Directive when establishing a recognition process; and

- the potential competitive impact of the need for an eligible ECAI to be able to meet prudent recognition requirements.

74. Concerning the US regulation on CRAs, the regulatory use of the concept of "nationally recognised statistical rating organisations" (NRSROs), described in Section 1, was criticized by some observers as a possible source of barriers to entry in the rating industry. According to these critics, important users of securities ratings have a regulatory incentive to obtain ratings issued by NRSROs; whereas, without NRSRO status, new entrants encounter great difficulties achieving the "national recognition" necessary to obtain the NRSRO designation.

75. On the other hand, users of credit ratings, and some others, point out that there should be substantive threshold standards for achieving NRSRO status for that term to have meaning. The NRSRO designation is meant to reflect the fact that marketplace views a rating agency's ratings as credible and reliable. Without this characteristic, it would be more difficult to rely upon ratings as a proxy for credit quality in regulation. Also the introduction of new and more stringent rules, which the SEC is considering, may have the effect of increasing barriers to entry into the rating market, both in the U.S. market and abroad.

76. In summary, the introduction of regulations pertaining to CRA's may have consequences for the barriers to entry to the market for credit ratings. In section 4, the alternative routes for the authorities with regard to regulations are further discussed.

Questions

**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?**

**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?**

## III. RULES OF CONDUCT DIMENSION

This section covers three broad areas included in the Commission's call to CESR for technical advice. Item 3.1 of the call for advice requests technical advice related to the issue of interest and conflicts of interest for credit rating agencies, item 3.2 deals with the fair presentation of credit ratings and item 3.3 requires advice concerning the relationship between issuers and rating agencies.

### Interests and conflicts of interest

#### Introduction

77. User and issuer confidence in credit ratings is vital for the good functioning of securities markets. In order to enhance market confidence a credit rating agency must issue independent, objective and high quality credit ratings and must be perceived to do so. A credit rating agency must not only operate independently, objectively and qualitatively but must also be perceived to issue independent, objective and high quality credit ratings.

78. Conflicts of interest between the rating agency and users or issuers may pose risks to ratings being independent. These risks may be caused by multiple relationships between the credit rating agency and the issuer whose creditworthiness the credit rating agency rates. It should be stressed that both real and perceived independence, objectivity and quality of credit ratings is important, as the mere perception of lack of independence, objectivity and quality of credit ratings can undermine confidence in them. This means that any degree of uncertainty about credit ratings, whether actual or potential, is to be reduced as far as possible. In the following, CESR discusses conflicts of interest as being problematic when they interfere with independency, objectivity and quality, but it may be sufficient that market participants perceive that these objectives are threatened, in order to pose a problem for the functioning of markets.

79. It should be emphasized that the mere existence of diverging interests or conflicts of interests between the relevant parties does not automatically imply a market failure. It is only when these conflicts of interests exist and impair the production of independent, objective and high quality credit ratings that a problem arises with regard to user confidence, upon which the good functioning of securities markets depend.

80. The IOSCO Code deals with conflicts of interest in several aspects. As a general measure, the Code suggests in the proposed measure 2.6 that internal procedures and policies to manage conflicts of interests should be developed. This particular measure deals with the identification, elimination, management and disclosure of any actual or potential conflicts of interest that may influence the credit rating agency.

#### Ancillary services

81. A credit rating agency may wish to provide ancillary services to issuers. These services may consist of risk management services, research services, data and analysis provision services, hypothetical ratings, also called rating advisory services. With ancillary services the credit rating agency may be primarily interested in increasing earnings by providing more services to an issuer than just credit rating assessments. A credit rating organisation may consider these services as a traditional and integral part of the rating process as these services may help to ensure both the transparency of the rating and the rating process itself. On the other hand, the issuer might be perceived to influence

the credit rating agency to the extent that its influence on the credit rating agency might increase by accepting ancillary services in addition to credit rating assessments. With multiple relationships between a credit rating agency and an issuer there are more possibilities for mutual influence, dependency or pressure. The rating process may give a credit rating agency access to confidential information. When carrying out other services, this information may be abused by employees or other departments in the scope of their ancillary services. It might be recommended that whatever the size of ancillary businesses is, it should be inappropriate for a credit rating agency to pursue any activity that might create conflicts of interest.

82. CESR thinks that the fundamental attributes of structured finance ratings, such as those assigned to asset backed securitisations or collateralised debt obligations are the same as those of corporate ratings. Therefore, the definition of credit ratings provided in section I of this paper should be understood as covering structure finance ratings. Notwithstanding, there are some differences between the rating procedures followed for the two types of ratings. In case of a structured finance rating, the sponsor has greater flexibility to adapt the features of the transaction in order to achieve the desirable outcome. This is why the CRA involved might play a more active role than in the case of a corporate rating, for example advising the sponsor about the definition of the characteristics of the transaction according to the rating level desired for each of the tranches of the structure.

83. It is important to note that the mere provision of additional services by a credit rating agency to an issuer in addition to credit assessment services should not constitute a market imperfection as long as the credit rating agency delivers and can be seen to deliver independent, objective and high quality credit ratings in which users have confidence. However, being only one of very few providers of credit rating services, the provision of other services should not in any way allow the credit rating agency to pressure an issuer into using these services for fear that the credit rating might otherwise be less favorable or that by taking on these services the rating might be more favorable.

84. Referring to the provisions of EU Directives[3], it might be possible to request a credit rating agency, to take all reasonable steps to identify conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and issuers they rate that arise in the course of providing any ancillary services. A credit rating agency might also be requested to take reasonable care to disclose their interests or indicate conflicts of interests concerning ancillary businesses they carry out.

85. In order to enhance user confidence in credit ratings notwithstanding that the credit rating agency supplies additional services to an issuer who's creditworthiness is being rated, the credit rating agency should ensure that the credit assessment process is completely unaffected by the existence of or potential for the said services. Measures 2.4 and 2.5 of the IOSCO Code deal with the actual or potential conflicts of interest that can result from other business relationships between a credit rating agency and an issuer than the mere provision of credit rating services. They state in general terms that ratings should be unaffected by such relations and that ancillary businesses should be separated from the rating process. In addition, users of credit ratings might be interested to learn whether (i) the credit rating agency has provided additional services to a particular issuer, (ii) the proportion such additional fees constitute against the fees earned by credit assessment services (Measure 2.8 of the IOSCO Code) and (iii) a credit rating agency has to have in place strict firewalls or other mechanisms aimed at safeguarding against any potential conflicts of interest and abuses (creation de Chinese walls, creation of parent companies where ancillary businesses are located, separation of staff exercising different functions, implementation of code of conduct providing procedures and measures to avoid any conflicts).

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[3] Article 6, paragraph 5 of the Directive 2003/6/EC, articles 5 and 6 of the Directive 2003/125/Ecand CESR's advice on Level 2 implementing measures for the market abuse directive.

## Payments by issuers

86. A credit rating agency's primary interest is to make a profit by providing credit rating services. To be able to make profits from providing credit rating services a credit rating agency needs to be able to produce independent, objective and high quality credit ratings that meet the needs of users, and investors. An issuer's primary interest however is to obtain the cheapest funding possible from investors which is why a favorable credit rating is desired. In these general terms the interests of the credit rating agency (profit maximalisation) and the issuer (most favorable credit ratings possible) diverge. Both issuer and credit rating agency need each other's information, although their interests may diverge.

87. A credit rating agency typically earns income from payments from issuers. Most credit rating agencies operate on an issuer-based fee scheme. A credit rating agency may be tempted to adjust the credit rating itself, in order to ensure new or continuing business from the issuer, to which effect an adjusted fee might be helpful.

88. The issuer-based fee scheme poses a risk that a credit rating agency may use the fee as an instrument to obtain more mandates from the same issuer or more mandates from other issuers, more business for other services from the same issuer, more extensive, accurate or timely information than provided to other credit rating agencies, or other competitive advantages in relation to other credit rating agencies.

89. Another risk with a fee scheme based on issuer payment may be that the issuer influences the credit rating agency by demanding certain favors in return for the payment of the fee. It may be the case that the issuer attempts to use the credit rating agency's dependence on payment as a means to advance its main interest, namely to obtain a favorable credit rating.

90. To the abovementioned criticisms large CRAs argue that no single issuer's fee accounts for a significant percentage of the CRA's revenue. The risk of issuers influencing the ratings might be higher in case of small CRAs since they could be rating only a limited number of issuers. Nevertheless, any attempt to change this business model could have a negative impact on competition as these smaller/emerging CRAs might need to rely on such a revenue stream.

## Unsolicited credit ratings

91. Quite a separate risk may come from the credit rating agency issuing unsolicited ratings. A credit rating is unsolicited if the issuer has not requested the rating. An unsolicited credit rating may pose a risk to the extent that it does not genuinely reflect all aspects relevant to the creditworthiness of an issuer. The issuer involved may be influenced to cooperate with the credit rating agency if indeed the credit rating does not adequately reflect the creditworthiness or otherwise is unfavorable, for whatever reasons. An unsolicited credit rating may be a way to put pressure on the relevant issuer to unwillingly cooperate or pay for the rating. On the other hand, unsolicited ratings allow a credit rating agency to obtain or increase market share or market coverage, which can be especially important for new entrants, as discussed in section 2.

92. With an unsolicited credit rating, the issuer normally does not pay the credit rating agency. This can mean that the credit rating has been issued without any undue influence by the issuer that is being rated. On the other hand, there is a risk that unsolicited ratings are set lower than the actual issuer risk level, as this could be used as a pressure from the rating agency to get cooperation and payment by the issuer. Uncertainty about whether a credit rating has been issued on an unsolicited basis and thus about the amount of information and issuer cooperation that the rating is based on, may undermine user confidence in these kind of credit ratings. Measure 3.8 of the IOSCO Code

provides for disclosure of whether a credit rating has been requested by the issuer and whether the issuer has participated in the rating process. This is one way of dealing with integrity risks related to unsolicited ratings.

93. A credit rating agency's reputation, depends ultimately on investors' confidence in its ratings. The reputation of a credit rating agency is at risk as soon as investors no longer take a credit rating for what it is supposed to be, namely an independent, objective and high quality opinion of a third party specialized in the assessment of the creditworthiness of issuers. However, with only a few global credit raters available to issuers, these agencies may have little incentive to police each other or their issuers in order to ensure that credit ratings are timely, accurate, independent, objective, high quality and take into account all possible relevant information about the issuer and the environment in which the issuer competes.

94. CESR therefore takes the view that, taking into account the risks mentioned above bringing about actual or potential conflicts of interests between a credit rating agency and an issuer, it is important to examine which means would:

- reduce those risks and ensure the issuing of timely, accurate, independent, objective, high quality credit ratings which take into account all possible relevant information about the issuer and the environment in which the issuer operates; and

- enable all users of credit ratings to assess themselves the extent to which a credit rating agency issues independent, objective and high quality credit ratings.

95. To the extent that payment for credit ratings by the issuer being rated brings along a risk to independence, objectivity, accuracy, timeliness or assessment of all relevant pieces of information of and about the issuer, the credit rating agency should ensure that all circumstances that impair or are perceived to impair the credit rating process are assessed and addressed in a structural way. It is primarily the CRA´s responsibility to ensure through policies and measures that the credit ratings to be issued are up to the highest possible professional standard, withstanding any divergence or conflict with other detrimental interest as a consequence of payments by issuers. In other words, a credit rating agency should manage the risk or the perception of risk that come with an issuer-based fee scheme by introducing policies and measures, as well as monitoring and enforcing their application. Most important, a credit rating agency should adopt and should be seen to apply a fee scheme which reduces issuer influence and enhances independence, objectivity, accuracy, timeliness en genuine assessment of all relevant information from or about the issuer throughout the entire credit ratings process. The proposed measures 2.1 – 2.16 of the IOSCO Code aim at policies and measures as well as at disclosure, for managing conflicts of interest in relation to payments by issuers.

## Capital or other interest links

96. Links between a credit rating agency and an issuer may be perceived to impair the independence and objectivity of the credit rating. To the extent that users of credit ratings are unsure whether there are any financial or other interest link between a credit rating agency and an issuer, this may impact negatively the market confidence on the independence, objectivity and quality of the rating process. If for example a credit rating agency has a direct or indirect financial link with an issuer that is being rated, or whose affiliates or investments are being rated, there may be room for some perceived influence on the credit assessment process in terms of independence, objectivity, accuracy, timeliness or quality. An owner of a CRA may wish to go for profit maximization of the group as a whole, rather than long-term quality maintenance of the credit rating process.

97. Credit rating agencies thus need to reassure the market that any kind of interest links with issuers do not influence the independence, objectivity and integrity of their credit ratings. .

98. The proposed measures 2.1 – 2.5 of the IOSCO Code is relevant also in the context of capital and other interest links.

Questions

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?

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?

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

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?

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?

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?

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?

## Fair Presentation

### Levels of skills of agencies' staff

99. Users of credit ratings should be able to have confidence in the quality of ratings. The willingness to provide or invest in capital depends on the reliability of relevant information, including a credit rating of the issuer involved. In order to enhance confidence of users of credit ratings primarily the credit rating agency is responsible for ensuring that all staff involved in assessing the creditworthiness of the relevant issuer is and remains sufficiently skilled.

100. The credit rating agency should devote and should be seen to devote the necessary resources to provide for adequately skilled staff. The credit rating agency should ensure that all staff involved in the credit rating process are and remain qualified to do so in terms of training, expertise and experience. The analysts involved in the assessments of all information related to the creditworthiness of the issuer must apply professional care and must thoroughly evaluate that information.

101. Any credit rating agency will have a strong incentive to take on and employ skilled staff as the quality of the assessment of all information available on the relevant issuer depends on the quality of staff. The reputational risk that a credit rating does not or is not seen to reflect a thorough and in depth appreciation of all relevant information should ensure that a credit rating agency takes all necessary measures to have skilled staff.

102. As the credit rating is an opinion concerning the creditworthiness of an issuer, the human factor is crucial for the production of a credit rating. However, it is important that whichever credit rating agency the issuer decides to request a rating from, the quality of the level of staff skills is up to the standard that can reasonably be expected of professional analysts.

103. In this respect, the proposed measure 1.4 of the IOSCO Code of Conduct Fundamentals states that a credit rating agency should use people who, individually or collectively have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied. Moreover, the proposed measure 1.7 states that a CRA should ensure that it has and devotes sufficient personnel with sufficient skill sets to make a proper rating assessment.

### Methodologies used for building credit ratings

104. Methodologies used in the rating process are fundamental in guaranteeing that a credit rating is of good quality and that it is perceived to be of good quality by all market participants. To meet these aims, methodologies used by CRAs have to fulfill some characteristics: they should be appropriate, strong and clear for users; this last characteristic implies that they should be adequately disclosed to the public.

105. With regard to the first element, methodologies used in the rating process should be appropriate to the purpose of a rating opinion: providing an evaluation of the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations. This does not necessarily imply that methodologies should be subject to some sort of standards, neither that only one or a few kinds of methodologies are appropriate, but rather that it is possible to assess (by the market, regulators, etc.), by using information available on the rating process, that these methodologies were sufficient to come to a reliable credit rating. To reach this purpose, two other elements are necessary.

106. The first one is that methodologies are rigorous, systematic and formalised (e.g. in written form). The second one is that methodologies are adequately disclosed, so that rating users could be effectively informed about all their characteristics and any updating of them.

107. A very relevant issue, from CESR's point of view, concerns the choice between establishing some forms of regulation on CRAs methodologies and creating conditions for adequate disclosure on the main aspects, so that all rating users can understand how and under what conditions a rating is produced.

108. In this regard, most market operators - in their answers to the Call for Evidence and in CESR's seminar - argued that the option of imposing regulatory criteria as to rating methodologies and processes should be considered inappropriate, because regulatory action in this field could erode individual quality and independence of the CRAs' analysis and could have a detrimental effect on the quality of information flow in securities market. For these reasons, most market operators consider that adequate disclosure concerning these aspects would be sufficient.

109. In addition to the requirements in this area of the IOSCO Code, the CRD prescribes recognition requirements in respect of an eligible ECAI's methodology. This makes the competent authorities of Member States responsible for assessing whether or not an ECAI's methodology meets the CRD requirements of objectivity, independence, on-going review and transparency and disclosure.

110. Issues concerning fair presentation were considered in the "Market Abuse Directive" and in the Commission Directive 2003/125/EC, implementing the Market Abuse Directive as regards fair presentation of investment recommendations. These issues have to be taken into account, because of similarities existing between investment recommendations and credit ratings, especially with regard to their information function for financial markets and operators, while recognizing also the differences, in terms of contents - credit ratings are not recommendations to purchase or sell any security - and risk of conflicts of interest - CRAs are normally not part of conglomerates operating in areas such as investment banking, differently from intermediaries which produce investment recommendations. With this regard, the Investment recommendations' Directive, in its preamble 10, after stating that credit ratings do not constitute investment recommendations, urges credit rating agencies to consider adopting internal policies and procedures designed to ensure that credit ratings published by them are fairly presented.

111. An alternative regulatory approach concerning rating's methodologies, does not establish rules on them, but provides for supervision on their implementation. This approach has the advantage of not establishing a strict regulation on the operativeness of CRAs, leaving them a certain level of flexibility without entrusting the supervision on the rating's process only to self-regulation.

112. Moreover, in considering the most appropriate ways of dealing with CRAs' methodologies, it is also important to take into consideration the important purpose - highlighted by many market operators - of guaranteeing a sort of common worldwide approach on CRAs, even considering the global activity of at least the biggest of them. This approach, with regard to methodologies, would imply creating the conditions to make ratings comparable within and across Member States for various categories of economic entities.

113. The IOSCO Principles and the IOSCO Code of Conduct Fundamentals deal with CRAs' methodologies in the Sections "Quality and Integrity of the Rating Process" and "Transparency and Timeliness of the Ratings Disclosure". Measure 1.1 of the IOSCO Code states that CRAs should adopt, implement and enforce written procedures and methodologies to ensure that the opinions they disseminate are based on a fair and thorough analysis of all relevant information available. According to measure 1.2, CRA's rating methodologies should be rigorous and systematic and ratings should be subjected to some form of validation based on historical experience. Moreover, measure 1.4 states that ratings should reflect all public and non-public information known, and believed to be relevant, to the CRA.

114. Finally, measure 3.4 establishes that the CRA should publicly disclose its policies for distributing ratings and reports. They should publish sufficient information about its procedure, methodologies and assumptions so that outside parties can understand how a rating was arrived at by the CRA; according to measure 3.9, the CRAs should fully and publicly disclose modification of these practices, procedures and processes.

115. With this regard, an important issue - which is object of consultation by IOSCO - concerns the opportunity of providing that methodology's changes should be disclosed to the issuers before these changes are applied to ratings. On the one hand, this rule would give issuers more information to understand the reasons of some possible changes in their own ratings; on the other hand, they could be tempted to use this information obtained in advance to try to influence the judgement of the CRA.

116. The objection against the regulatory approach on rating's methodologies - that imposing rules on them could erode individual quality and independence of the CRAs' analysis, and consequently could harm the quality of information flow in securities market - seems to have strong support with market operators in general. In fact, a regulation too strict on methodologies, besides reducing the independence of CRAs and potentially slowing down the process of innovation of rating's methodologies and analyses, could transmit to the market the wrong impression that regulatory authorities are able in some ways to guarantee a certain level of quality of rating.

117. Therefore, it may be unsuitable that regulation addresses all aspects of CRAs methodologies. However, it could be appropriate to establish rules - which could be implemented in different ways, depending on the regulatory or non-regulatory options chosen - for specific aspects of methodologies these could be particularly relevant for the reliability of ratings and for the provision of correct information to investors. These aspects could be the following:

- Disclosure and explanation of the key elements and assumptions underlying the rating decision. This kind of information may be crucial for investors, because it explains what are the most important factors on which the credit rating is based. With this regard, IOSCO Code's measure 3.5 states that CRAs, when issuing a rating, should explain in their press releases and reports the key elements and assumptions underlying their rating decision. The CRD's also has explicit requirements in respect of transparency and disclosure of an ECAI's methodology. Annex VI, Part 2, section 1.4.7 requires that, "Competent authorities take the necessary measures to assure that the principles of the methodology employed by the ECAI for the formulation of its credit assessments are publicly available as to allow all potential users to decide if they are derived in a reasonable way".

- The indication of some forms of risk warning on elements whose changes can mostly influence the credit rating, including a sensitivity analysis or other methods appropriate to describe the effects of changes of some relevant factors on credit rating. These elements are particularly important when there are some events concerning the issuer that could occur with a certain probability, but are not certain. This kind of analysis would allow to better disclose to investors the risk that changes in these factors influence rating and the “size” of this effect. On the other hand, it is not possible to give a full range of potential areas of sensitivity to the rating, where the information content may be limited. The qualitative judgements that are part of ratings also make sensitivity analysis more difficult.

- Updating of ratings: it is crucial, to guarantee the timeliness of information provided to the market, that CRAs initiate a review of the status of the rating when they receive any information that might reasonably be expected to result in a rating action, and subsequently update on a timely basis the rating, as appropriate, based on the results of such review. IOSCO Code deals with this aspect in its measure 1.9, stating that CRAs should monitor on an ongoing basis the rating and update it on the basis of the availability of new relevant information and of the result of the rating review.

- The inclusion within a rating's opinion of some market indicators, like credit spread or credit default swap, which could represent for investors an additional information and a benchmark. The presence of these elements would improve the information available to investors. It can also be argued, however, that investors can do this benchmarking by themselves, relying on their own perception of which benchmarks are most appropriate to use.

118. Besides the advantages (just described) of regulating these aspects, essentially consisting in the improvement of information available to investors to form a well-founded judgement on the content and the meaning of rating, a potential disadvantage consists in an excess of regulation, compared to the hypothesis of providing that CRAs should only disclose methodologies they decided to adopt (simple disclosure).

*Questions*

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?

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?

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

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?

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?

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?

## Relationship between issuers and rating agencies

### Introduction

In considering the issues included in the Commission's call for advice, CESR has not only considered the requirements that will be introduced across the European Union as a result of the implementation of the Market Abuse Directive and the related implementing Directives, but also the requirements of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies published for consultation on 7 October 2004 ("the IOSCO Code").

Access to inside information by credit rating agencies

- *the existing lack of clarity and harmonisation of legislation relating to access to inside information from issuers by rating agencies* (extract from the Commission's call for technical advice).

119. CRAs perform a service to issuers as well as to investors by reducing information asymmetries, thereby lowering the cost of capital for issuers. CRAs collect and analyze information from a variety of sources and frequently the information used by a CRA in assigning a rating will be a combination of information that is publicly available and that which is not public and has been obtained directly from the relevant issuer[4]. Most of the publicly available information concerning an issuer will be derived from the information released by the issuer in its disclosure statements, so the ongoing disclosure obligations that apply to issuers become vitally important to the rating process.

120. The amount of non-public information that a CRA is able to obtain from an issuer will vary according to the relationship between the issuer and the individual CRA. This information might include more detailed information which forms the basis of the information disclosed in the issuer's regular disclosure statements or more general information about the issuer's future strategic plans. The Market Abuse Directive provides a definition of "inside information" and it seems unlikely that all non-public, confidential information that an issuer holds (and could theoretically make available to a CRA) would fall within the definition of inside information since the focus of the definition is on information that would be likely to have a significant effect on the price of financial instruments.

121. The Market Abuse Directive not only defines inside information for the purposes of defining the offence of insider dealing, but also requires issuers whose securities are admitted to trading on a regulated market to disclose inside information as soon as possible. The Directive also sets out some relatively limited situations in which an issuer may delay the disclosure of inside information, for example if it relates to a matter which is subject to ongoing negotiations, provided the issuer can keep the information confidential. Once implemented, the Directive will harmonise the standards of disclosure of inside information by issuers across the EU.

122. The requirements of the Market Abuse Directive mean therefore that there will only be limited circumstances in which an issuer can legitimately be in possession of inside information that has not already disclosed to the market. It is only in these circumstances that it would be possible for a CRA to then have access to non-public information that amounts to "inside information", as opposed to information which is confidential to the issuer, but which is not required to be disclosed.

123. Assuming that an issuer does possess "inside information" and is entitled to delay the disclosure of this under the requirements of the Market Abuse Directive, the question that follows is whether a CRA can legitimately have access to that information.

124. The Market Abuse Directive makes explicit reference to the fact that issuers may disclose inside information to third parties in the normal course of their activities assuming that the recipient owes the issuer a duty of confidentiality. If the confidentiality of the information is not maintained, the information must be disclosed publicly as soon as possible. The disclosure of inside information under any other circumstances is itself likely to amount to an offence under the Market Abuse Directive.

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[4] There may be occasions when a rating has been assigned purely on the basis of publicly available information concerning the issuer and this is more likely to be the case where a rating has not been solicited by the issuer. See further discussion of issues concerning unsolicited ratings.

125. It is CESR's understanding that CRAs frequently obtain significant amounts of non-public information from issuers, but that much of this would not amount to "inside information" under the Market Abuse Directive. Many CRAs also say that they have policies and procedures in place to ensure that any non-public information received from an issuer remains confidential. The consultation draft of the IOSCO Code also contains specific provisions requiring CRAs to have such policies and procedures to ensure the confidentiality of information received from issuers.

126. The current draft of the IOSCO Code also contains a provision[5] which touches on the question of whether a CRA, when it has been given "inside information" by an issuer, should itself seek to ensure that it is disclosed, either through encouraging the issuer to do so, or by disclosing the information to the market themselves. The Market Abuse Directive however places the responsibility for disclosure of inside information on issuers and explicitly permits issuers to delay disclosure in certain limited circumstances. As far as the EU is concerned therefore, there is no obligation on CRAs to make public inside information that issuers themselves have not disclosed.

127. The Market Abuse Directive applies to CRAs in the same way as it applies to others in terms of how inside information should be handled. In summary in this context its provisions address:

- the definition of inside information;
- an issuer's ability to delay the disclosure of inside information and thereby create the opportunity for an issuer to be in a position to possess inside information that others might want to access; and
- the framework within which issuers can provide inside information to third parties without simultaneously making a public disclosure.

- *the need to investigate appropriate measures to ensure that inside information is not inadvertently disseminated, selectively disclosed or misused in other ways* (extract from the Commission's call for technical advice)

128. The various requirements concerning the dissemination of inside information have already been discussed from the perspective of the issuer. One of the greatest risks associated with the circulation of inside information is that those who possess it might trade in financial instruments to which it relates. This is a general risk which exists regardless of the status of the individual or legal entity concerned, but it is a risk that is addressed by the Market Abuse Directive which prohibits insider dealing by both natural and legal persons. This includes CRAs, so to the extent that insider dealing by CRAs or their staff is perceived to be a risk because of the possibility that they may have access to inside information, this is already addressed.

129. The discussion so far has focused on access to inside information that may be held by an issuer, in accordance with the mandate given to CESR. However, CESR considers that there is a related issue that should be discussed, namely where inside information is generated not by an issuer, but by a CRA. A rating action such as a change in rating or even the announcement by a CRA that they are about to review a particular rating will in many cases itself amount to inside information. Such an announcement is likely to be specific, particularly in the event of publication of a rating itself, and is often likely to have a significant impact on the price of related financial instruments which may be admitted to trading on a regulated market.

130. One reason why rating actions are themselves likely to influence the prices of related financial instruments is because of the additional information that CRAs usually have access to compared to

[5] Paragraph 3.11 states "Where a CRA is made aware of non-public information of the kind required to be disclosed under applicable laws and regulations, depending on the jurisdiction, the CRA may be obligated to make this information available to the public. However, prior to doing so, the CRA should indicate to the issuer its intent to release this information and permit the issuer to immediately disclose this information itself. The timeframe a CRA should provide an issuer to make this disclosure should be limited".

the market as a whole. For ratings that are compiled purely on the basis of publicly available information, it seems very unlikely that the rating will itself have an impact on prices, though it may be a possibility if the CRA is regarded as being particularly influential or its analyses as being particularly accurate and significant. This suggests that those ratings based only on public information are far less likely to amount to inside information.

131. Similar considerations therefore apply to how CRAs should disclose their ratings and rating actions as to how issuers should handle inside information. The consultation draft of the IOSCO Code includes a number of requirements setting out how CRAs should give issuers an opportunity to correct any factual inaccuracies that have been relied upon in determining the rating and it is our understanding that the major CRAs will usually give an issuer a short amount of notice before publishing a rating change. Thus a CRA is often likely to be generating inside information itself and might be providing this to an issuer ahead of making it publicly available. This creates a number of risks, including how and when this inside information is disclosed to the market, the controls in place to ensure it is not selectively disclosed to others before the market, and the controls in place to ensure it is not misused.

132. The requirements of the Market Abuse Directive outlined above require an issuer to disclose inside information as soon as possible which could be interpreted as requiring the issuer in these circumstances to itself announce the rating change before the CRA does. It is CESR understanding that CRAs often, but not always, give issuers this opportunity to check that any factual statements that are due to be made by the CRA when announcing the rating are correct and to ensure that no confidential information is inadvertently disclosed by the CRA. It might be the case that a CRA would be far less willing to share such information with the issuer in advance of publishing the information if the result was going to be that the issuer themselves would disclose the rating. An analogy could be drawn here to the situation regarding the publication of investment research recommendations, even though it is recognized that these differ from rating opinions. An investment firm which is about to publish research may also contact the issuer in advance of publication to ensure that no factual inaccuracies are contained in the report. Some investment research recommendations could also amount to inside information for reasons similar to those outlined above in respect of ratings, particularly where the publisher of the research is highly regarded. It is possible that that in these circumstances, the issuer themselves might consider that they need to publish the information themselves before the 'owner' of the research can.

133. CESR's advice on level 2 implementing measures for the Market Abuse Directive (document CESR 02-089d) provides a list of examples of facts or decisions that would usually concern the issuer indirectly and therefore, there would be no legal basis to require prompt disclosure under article 6.1 of the Market Abuse Directive, because this article only applies to issuers and to information that directly concerns them. Among these examples set out by paragraph 36 of the abovementioned advice, CESR included "the coming publication of rating agencies' reports, research, recommendations or suggestions concerning the value of listed financial instruments".

134. It could be counter-productive to take the view that an issuer itself is under an obligation to publish a rating change in circumstances where a CRA gives it advanced notice of an imminent rating announcement. It is in the market's interests to ensure that rating announcements do not themselves contain any factual inaccuracies relating to the issuer and there would be no incentive for a CRA to give an issuer advanced notice of a rating if the issuer was then going to itself publish it. It is possible that with this practice there could be a short delay between the decision to issue a particular rating and publication of that rating.

135. Those within a CRA who know about rating decisions before they are published, or who have access to any inside information obtained from an issuer could themselves trade on the basis of this information, or could themselves pass it on to others. Some critics of CRAs have expressed concern regarding special access to information that subscribers to a CRA's services may receive. These concerns are that subscribers to a CRA's services may receive valuable analytical insights that may

not be publicly disseminated and that this might include inside information which has been obtained as part of the rating process. This might occur due to the detailed reports that might be received by subscribers which explain the basis for a rating or because some CRAs permit subscribers to contact their analysts directly to ask questions about the reasoning behind a rating decision. There is also a risk that a CRA's rating decision itself could be communicated to subscribers ahead of being made available to the market as a whole.

136. As discussed above, the provisions of the Market Abuse Directive covering the use of inside information and the disclosure of it to others will also apply to CRAs and any inside information they possess. The framework established under the Market Abuse Directive permitting issuers to disclose inside information to others who owe a duty of confidentiality only applies to issuers and does not permit the widespread circulation of inside information from one entity or individual to another. Hence a CRA or a member of their staff who has access to inside information of any sort is prohibited from passing on this inside information to anyone else except in the normal course of their employment, profession or duties. It does not seem appropriate that a CRA or its staff could argue that selectively passing inside information to others formed part of their employment, profession or duties, a view bolstered by the draft IOSCO Code which clearly discourages this at paragraphs 3.10 and 3.16-3.18. Any disclosure of inside information by a CRA or its staff therefore would appear to constitute an offence under the Market Abuse Directive, other than in the situation outlined above where an imminent rating decision is communicated to an issuer on a confidential basis for the purpose of checking the accuracy of the information it is based on etc. Any recipient of information in these contexts, including issuers themselves, will also be committing an offence under the Market Abuse Directive if they deal on the basis of inside information they are given.

137. While it appears that the Market Abuse Directive's provisions address these risks, another safeguard would be to prevent the communication of any information to subscribers that is not also made public. It is important to note in this context however that because CRAs differ in their business models, any additional regulatory intervention in this area may have a wider impact. Subscription services form the primary source of revenue for smaller CRAs and new entrants, meaning that restrictions on selective access to information may adversely affect smaller CRAs that rely on these subscriptions. Several of the larger CRAs have indicated that their analysts take questions from the public regardless of whether the individual subscribes to their services while others that provide more detailed reports to subscribers justify this access to more detailed information on the grounds of the cost of making this information available.

138. In summary, the provisions of the Market Abuse Directive in this context appear to prohibit:

- the disclosure of inside information from CRAs to others, including subscribers; and
- any trading using inside information, regardless of how the individual or legal entity has acquired the information.

- *the need to ensure a level playing field between credit rating agencies* (extract from the Commission's call for technical advice).

139. As discussed above, the rules governing the disclosure of inside information by issuers within the EU are being harmonised by the provisions of the Market Abuse Directive which will limit the amount of inside information that issuers will legitimately possess that could be provided to a CRA. At the same time, a harmonised framework will exist giving issuers the ability to provide inside information to others on the basis of a confidentiality agreement.

140. There could still be occasions however where a level playing field with respect to the availability of information does not exist between CRAs. This is most likely to occur in the context of "unsolicited ratings" particularly if the relevant issuer decides not to co-operate with the CRA in

question. As such, the rating process behind an unsolicited rating may lack the type of issuer input and, depending on the circumstances, access to non-public information that a solicited rating may incorporate. This may impair the quality of the rating and some might argue that a level playing field (in terms of the information available to them) for all CRAs would be desirable. This issue is addressed below in the section dealing with the relationship between issuers and CRAs under "the need for all rating agencies to have access to the same information from companies (rating agency data room)".

- *the provisions of Articles 1,2,3 and 6 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/124/EC implementing the Market Abuse Directive as regards the definition and public disclosure of inside information while recognising the differences between credit ratings and investment recommendations.* (extract from the Commission's call for technical advice)

141. These provisions relate to the definitions of inside information and insider dealing and the requirements concerning the disclosure, including delaying disclosure and selective disclosure, of inside information by issuers respectively and have been used as the basis for the above analysis.

### Other issues concerning the relationship between issuers and rating agencies

142. In contrast to the previous section dealing with access to inside information, there are no specific requirements in EU law governing the relationship between issuers and CRAs. This is an area however that the current version of the IOSCO Code addresses to some extent and CESR has had regard to the provisions of the Code in determining what further measures might be appropriate.

- *the need to ensure that issuers periodically have the opportunity to discuss with rating agencies the assumptions and fundamental determinants of their ratings* (extract from the Commission's call for technical advice)
- *the need for issuers to understand how rating agencies restate the figures they give them;* (extract from the Commission's call for technical advice)

143. Most of the perceived problems in this area arise from issuers not understanding how a CRA has arrived at a particular conclusion when providing a rating, meaning that some rating actions may be viewed by issuers as unfair, inappropriate or even unjustified. There is clearly a tension between the need for ratings to be fair and for CRAs to be independent from the issuers they rate on the one hand, and the need for issuers (and the market) to clearly understand what forms the basis of any particular rating decision. Taken to an extreme, if an issuer fully understood precisely how a CRA came to a particular decision, it might attempt to influence future ratings by only providing information it believed would result in a favorable rating. This could result in less information being provided, or worse, it might result in the provision of inaccurate or misleading information in the hope that this would be result in a more favorable rating. Two specific provisions of the current draft of the IOSCO Code address these risks in paragraphs 1.14 and 2.3 respectively:

"*The CRA and its employees should not, either implicitly or explicitly, give issuers any assurance or guarantee of a particular rating prior to a rating assessment.*"

"*The CRA should not forbear or refrain from taking a rating action based on the potential effect (economic, political or otherwise) of the action on the CRA, the issuer, an investor, or other market participant.*"

144. It is clearly important that issuers and other market participants understand the methodologies employed by CRAs and that any changes to these are made public before they are implemented. It is also important for both the issuer and market participants to understand the key determinants for any particular rating to appreciate fully its meaning and relevance. A rating opinion is however, the opinion of the CRA that issues it, meaning that there are likely to be a number of subjective judgements made during the rating process. While many of these assumptions are likely to be published along with the rating, it is clearly possible that others, including the issuer, will disagree with some of the CRA's decisions.

145. Paragraph 3.4 of the current IOSCO Code requires a CRA to *"publish sufficient information about its procedures, methodologies and assumptions so that outside parties can understand how a rating was arrived at by the CRA".* In terms of specific rating decisions, the Code requires the following:

"*Where feasible and appropriate, prior to issuing or revising a rating, the CRA should advise the issuer of the critical information and the principal considerations upon which a rating will be based and afford the issuer an opportunity to clarify any likely factual misperceptions or other matters that the CRA would wish to be made aware of in order to produce an accurate rating. The CRA will duly evaluate the response.*"

- *the need to ensure that information published by rating agencies (alongside rating opinions) is accurate and the role issuers are to play in such a process* (extract from the Commission's call for technical advice)

146. As stated above, the IOSCO Code currently requires a CRA to give an issuer an opportunity to comment on the basis of a rating to help ensure that the CRA's rating is accurate. In addition, there are broader measures that apply to the conduct of a CRA in this regard, designed to prevent the publication of inaccurate or misleading information. Firstly the IOSCO Code contains a number of provisions in paragraphs 1.1 to 1.8 relating to the quality of the rating process, including specifically at paragraph 1.6 *"The CRA and its analysts should take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of an issuer or obligation".* Second, the Market Abuse Directive makes it an offence for anyone to disseminate false or misleading information where they know or ought to know that it is false or misleading where this is likely to create a false or misleading impression in relation to a financial instrument admitted to trading on a regulated market.

- *the importance of rating agencies archiving all information related to a rating so that a rating decision can be explained to issuers at a later stage* (extract from the Commission's call for technical advice)

147. Given the amount of information available to CRAs when making their rating decisions, both public and in many instances non-public, it is important that CRAs can not only explain their rating decision at the time the decision is taken, but also on a historical basis. This provides a safeguard against inconsistent application of a CRA's own stated methodologies, but may also be useful if a particular rating decision is called into question at some later date, perhaps due to a particular change in the relevant issuer's circumstances. It may then be necessary to explore in some detail the basis for the CRA's previous ratings for that issuer. This is no substitute for being able to explain a rating decision to an issuer (or to the wider market) when it is first announced.

148. Again, this issue is addressed in the current version of the IOSCO Code, albeit in general terms. Paragraph 1.5 requires that:

"*The CRA should maintain internal records to support its credit opinions for a reasonable period of time or in accordance with applicable law.*"

149. This does not explicitly require all the information relating to a rating to be retained, but the internal records supporting the opinions will, if they are accurate, highlight the key pieces of information that were taken into account. There is no generally applicable requirement in EU law applying to record-keeping by CRAs, but such requirements are common in the context of investment firms and credit institutions. That said, there may be different domestic legal requirements in EU jurisdictions governing the length of time that such records should be retained if they are to be used subsequently in any kind of proceedings. For example, in CESR's technical advice to the European Commission on various implementing measures for the Market Abuse Directive, a specific requirement to keep insider lists did not specify a definitive time period for the retention of the records, but was instead framed in a way that specified a minimum retention period of 5 years.

- *the need for all rating agencies to have access to the same information from companies (rating agency data room)* (extract from the Commission's call for technical advice)

150. As discussed above, the lack of a level playing field in terms of access to information for CRAs is likely to occur in the context of unsolicited ratings. It may also occur even where an issuer is willing to co-operate with a CRA and might be an area of risk to the quality of ratings if the issuer is in control of what information it provides to CRAs.

151. If all CRAs had access to the same information, any differences in ratings could be as a result of a different methodology used to analyze the information. Since these methodologies will be public given the requirements of the IOSCO Code, there will be some transparency in this area. Issuers who are seeking a rating are, however, then likely to approach whichever CRA they consider is likely to give them the most attractive rating for a given price. This might be regarded by some as a positive development likely to reduce costs, but there are also very real risks that it might lead to a reduction in the quality of ratings as they become "commoditised" and competition becomes focused on the desired outcome of the rating process.

152. A broader issue to be considered in this area is why a level playing field would be desirable. If a rating is being initiated by a CRA rather than an issuer, it suggests that the issuer does not require the rating for capital raising purposes for example. It may instead be driven by the CRA in an attempt to increase their coverage, particularly for a smaller agency. A level playing field would reduce the advantage that large, established CRAs have in terms of their established relationships with issuers that give them access to non-public information. There could however be negative consequences for issuers who have commented on the amount of senior management time that is devoted to dealing with CRAs during any rating assessment. The prospect of issuers having to devote the same attention to all CRAs that approach them is likely to place a significant burden on a company. This is particularly true given that we understand that a significant amount of the non-public information that is provided to CRAs relates to strategy or the approach of senior management to various issues – such information is likely to be difficult to compile in a "data room" in contrast to more factual information such as detailed breakdowns of financial information that lies beneath published financial information.

153. The relationship between an issuer and a CRA is likely to vary considerably depending on the circumstances of the issuer and the reasons why a rating is being sought. For ratings sought by CRAs themselves and not by issuers, a level playing field in terms of the information available would be of benefit, particularly to smaller CRAs trying to increase their coverage, but there is a question as to whether it is appropriate to mandate that an issuer must provide the same information to a CRA it does not want to engage with that it has made available to a CRA that it has

willingly co-operated with. We note that no similar requirement exists in the context of issuers' contacts with research analysts where similar demands to meet with senior management are often made.

Questions

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?

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?

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?

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?

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?

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

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?

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?

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?

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?

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?

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

## General discussion

154. In section 3, a number of issues have been discussed, where there could be a need for rules of conduct for the rating agencies. In this section, we try to summarize the options that exist for the authorities to deal with these problems in a general way, rather than raising the issues one by one. The different options also take the discussion from section 2, on barriers to entry in relation to regulation, into account.

155. A discussion of different options may lead to the impression that there are very clear-cut boundaries between the different options. However, it should be stressed that there is rather a spectrum of different options, where elements of different options can be mixed. The discussion of different options below should be seen in this context.

156. A starting point in this section, as well as the earlier ones, is that the IOSCO Code of Conduct has been developed and will be available in a form that has been accepted by a worldwide collective of securities regulators. This means that European securities regulators will expect that the rating agencies that are active on European markets will see this Code as a point of reference for their own behavior. The questions that have to be dealt with for the Commission are thus whether some enforcement of the Code is needed, and to what extent any enforcement will apply just to the Code in itself, or to either a wider or a narrower set of rules than the Code.

157. The most limited reaction from the Commission would be to not intervene in the market in any respect. In this case, it would be up to the rating agencies to show to what extent they comply with the Code, and for the market to react to this.

158. A way to strengthen the status of the Code, without formal involvement from the public sector, would be to propose some form of market-based means of certification and/or enforcement, where a structure for checking compliance with the Code would be left to a structure within the market, without participation of the public sector. Such certification/enforcement could be organized in different ways. One could be to set up a special body, such as an arbitration court, that would judge whether a particular rating agency complies with the Code or not. Another way would be to let the auditors give their view on compliance.

159. Market based enforcement can be seen as a weaker form of enforcement, since non-compliance would not lead to any legally binding sanctions. Market enforcement means that the enforcement relies on the acceptance by rating agencies of any decisions made by the enforcement body. One way for the authorities to strengthen the market enforcement would be to appoint a particular structure for market enforcement, and give this structure legally binding sanctions.

160. Another way of enforcing rules of conduct is to asses these in a parallel process to the CRD recognition process[6]. The main objective of the CRD recognition is not to affect rating agencies behavior on the markets – it is rather to get assurance that external ratings used in the CRD are objective and of high quality. However, in some aspects the means to achieve this objective are the same as the ones that the rules of conduct are supposed to achieve. For instance, there are recognition criteria in relation to objectivity, independence, credibility and transparency, which

[6] It should be emphasized that CESR has no intention to suggest any changes to the proposed CRD. The option that is discussed here should be seen as a means to take advantage of the process that the CRD suggests, without interfering with material content of the relevant provisions in the CRD.

reflect a lot of the areas covered in the Code. It should be stressed however, that the fact that the same areas are addressed does not mean that the material standards will be the same. Nevertheless, it can be expected that some of the elements in the Code of Conduct will be assessed through the CRD recognition process.

161. The CRD process will only cover those rating agencies that want to be recognized for external ratings in the CRD. It is not self-evident that all rating agencies will have an interest in becoming recognized in this respect, especially if the requirements are perceived to conflict too much with the way the agency wants to operate its business. This means that the CRD criteria are not necessarily a much stronger means of enforcement than market-based enforcement. It is dependent on the willingness of the agency to take part in this process and thereby to comply. It is too early to assess how strong the market pressure will be on the rating agencies to take part in this process.

162. Even though the Code of Conduct covers a broader perspective of issues than the CRD recognition criteria, it would be possible to use the Code as a benchmark for the CRD criteria that are connected to objectivity, independence, credibility and transparency. It could be argued that the compliance with the Code is a part of any sound rating business, and that it is reasonable that this level of soundness is demanded from any institution that the public sector relies on for regulatory purposes. One advantage of this would also be that the authorities would approach particular issues consistently.

163. The strongest enforcement is achieved if rating agencies are required to register with the authorities in order to be allowed to operate in European markets. A registration scheme would be addressed to specifically deal with the areas discussed in the previous sections, where rules of conduct have been considered. A registration scheme could be limited to the IOSCO Code, but it could also be extended with stricter or more specific rules. It could also be considered that some parts of the Code could be left out of the registration scheme, and left to market mechanisms. This could however be perceived as a signal from the authorities that some of the rules in the Code are of little importance, and this could hardly be justified without some arguments as to why regulatory control of this particular rule is harmful, but not the others.

164. Regulatory control of rules of conduct can be set at different levels of oversight. A relatively light touch would be to focus on how the rating agencies' internal rules of conduct correspond to the benchmark that the registration scheme use (the IOSCO Code, or an extended/limited version of it). More intrusive would be to control whether the rating agency actually complies with the rules, through supervisory measures of the agency. Regardless of the level chosen, sanctions must exist in order to force agencies to comply if they are found out not to be doing so.

165. If registration is to be used, the registration can be organized in different ways. In European financial regulation, the most common approach is the single passport concept. This means that financial companies in most areas can apply for a license in one European country, and then operate in other countries through branches. This structure could be used also for registration of rating agencies. Rating agencies are more international than other financial businesses. They rate companies in countries where they have no presence at all. It could be argued that it would be reasonable to rather have one registration for the European market as a whole. However, no European body exists that performs tasks of this kind at present, so that would have to be developed.

166. In this respect, CESR has recently released its consultation paper "Which supervisory tools for the EU securities markets?" (Ref:04-333f). This report analyses the options that could be explored with a view to improving the efficiency of the co-operation among regulators in the post-FSAP phase. One of the ideas put forward by the report is that there could be cases where the present system (home/host relationship: mutual recognition) could not be developed to provide proper solutions to the question of supervisory convergence. In such cases, the consultation paper asks whether it would be appropriate for CESR to take single EU decisions, once a number of tests have

been satisfied. As it was mentioned above, this option would require the modification of CESR's legal profile. The report sets out several examples where EU decisions could be explored, such as the operation of CRAs (a single permit for the EU).

167. Registration would also have to be considered in the context of the CRD recognition process. It has already been stressed that rules of conduct could be assessed in a parallel process to the CRD recognition process. If registration is introduced, it could be considered that the registration and the recognition process should be merged. One problem if this is to be done is that both banking regulators and securities regulators would have legitimate interests in this process, and it is not self-evident how this process could be organized. Another problem is that the objectives of registration and CRD recognition are different. In particular, it is likely that the criteria for CRD recognition will be stricter in some aspects, since the bar for a rating agency to have its ratings used for regulatory purposes probably should be higher than the bar for getting a license to operate on the market.

## Regulatory options

168. While realizing that there is a spectrum of options rather than a limited number, CESR has found it useful to discuss a set of options in more depth, focusing on what the advantages and disadvantages (pros and cons) are with the different options. These options are synthesized in the table below: the rows show the "substance" of the policy options, i.e. the kind of rules to which each option is referred, which have been described more in details in section 3, whereas the columns describe the "forms" by which the different options are implemented. Moreover, each different option is inserted within the table, based on the "combination" of substance and form.

169. The substance of the policy options consists of the rules included in the IOSCO Code of Conduct, in the criteria for recognition established by the CRD and possible additional criteria or rules introduced at EU level. The different forms of implementation of the regulation are self-regulation, certification or enforcement of compliance with IOSCO code by a third party (private or public), checking of compliance with the IOSCO Code in a parallel process to the CRD's recognition process and finally formal registration at EU level, which could be based essentially on compliance with the IOSCO Code ("light registration/regulation") or on more stringent criteria that could be quite similar to those established for the CRD's recognition ("strong registration/regulation"). Included in the registration system could also be a kind of supervision or regulation.

<table>
<tr><th rowspan="2">Form<br>Substance</th><th rowspan="2">Self-regulation</th><th rowspan="2">3rd party certification or enforcement</th><th rowspan="2">CRD's recognition</th><th colspan="2">Formal EU Registration/ Regulation</th></tr>
<tr><th>European Authority</th><th>National Authorities</th></tr>
<tr><td>IOSCO Code of Conduct</td><td>Options 5/6</td><td>Option 4</td><td rowspan="2">Option 3</td><td>Options 1/2</td><td>Options 1/2</td></tr>
<tr><td>CRD's criteria</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Additional criteria/rules</td><td>Option 5</td><td></td><td></td><td>Option 1</td><td>Option 1</td></tr>
</table>

## Option 1: Registration/Regulation Regime (I)

170. A first option consists of the establishment of a European Registration Scheme for the registration of rating agencies in Europe. The accomplishment of registration could be:

- attributed to an European authority (like CESR);
- put into effect by the creation of a unique list at European level which would be "filled in" by CESR members, which receive the application for registration by the CRA.

171. The registration would be granted on the basis of the assessment of well-specified criteria involving credibility, independence and the expertise of the staff of the CRA, adequate funding, the existence and disclosure of proper procedures concerning the rating process and particularly for identifying and dealing with conflicts of interest, the reliability of ratings and an adequate disclosure of them and of related information.

172. Moreover, the respect of these criteria on an on-going basis could be implemented by a supervision performed, according to the solution chosen, by the European authority or by the securities regulator which received the CRA's application. Also the compliance with the criteria on an on-going basis could be monitored by each CESR member within its own financial market. Each single Authority would communicate eventual breaches – and consequent exclusion from the list, if this is the case – to the European authority or to the CESR member which put that CRA into the list.

173. Pros: Introducing an European Registration Scheme with regard to CRAs would, firstly, avoid the situation where CRAs – which are international organizations operating in many countries – have to register in each single European country. This registration could also be used as reference for other regulatory measures or represent an indication for issuers of reliability of these CRAs, in the European regulators' opinion. Moreover, the European registration model could be very useful especially for new or smaller agencies, which are trying to enter or to develop within the rating market, because they would receive from it recognition of their expertise.

174. Cons: On the other hand, the presence of an European Registration system such as previously described would introduce another regulatory system for CRAs in the European Union, in addition to the recognition system currently proposed in the context of the Capital Requirements Directive (CRD). This aspect would obviously imply an at least partial duplication of the "regulatory" burden for CRAs, which would have to deal with two information flow requirements and, at least with regard to some countries, two competent authorities. Moreover, in the case of registration and recognition being based on at least partially different rules and criteria, this difference could consequently determine two lists of potentially different credit rating agencies. The presence of two regulatory systems could also contribute to increase barriers to entry in the rating's market. Finally, two regulatory systems establishing too many (and/or too strict) criteria could contribute to give investors the impression of a sort of guarantee, given by regulators, of quality of ratings.

## Option 2: Registration/Regulation Regime (II)

175. Another form of European Registration could be similar to that previously described, in terms of regulatory authorities involved in the registration process (European authority or list at European level filled in by the single securities regulators), but quite different in terms of the criteria required for the registration.

176. In fact, a lighter form of registration could be based on the implementation of the IOSCO Principles on CRAs – as specified in the proposed IOSCO Code of Conduct Fundamentals ("IOSCO

Code" or "the Code") whose compliance with, according to this solution, would become mandatory in the European context – and of few other possible "light" requirements aimed to establish a "general framework" for CRAs.

177. Moreover, in this regulatory system, the compliance with the IOSCO Code by the CRAs on an on-going basis could be monitored by each CESR member within its own financial market. Each single Authority would communicate eventual breaches – and consequent exclusion from the list, if this is the case – to the European authority or to the CESR member which put that CRA into the list.

178. Pros: In addition to the advantages already described for the previous option, this form of registration would present some further positive aspects. Firstly, by providing the inclusion among requirements for registration of the implementation of the IOSCO Code, which is a Code diffused worldwide, this regulatory option would allow to take into account international best practices which are incorporated in the Code itself. Moreover, this inclusion of the IOSCO Code in regulation would probably allow a degree of enforcement of the Code stronger than enforcement in a context of self-regulation. This kind of registration would attribute a recognition of expertise and experience to CRAs in a quite flexible way, because it does not imply the fulfillment of many requirements, so it is more based on the current performance and behavior with regard to the rating process than to the presence of a consolidated structure. In this way, barriers to entry for new or recent entrants would be lower. Finally, this provision is more consistent with the regulatory system established in the context of CRD, because it implies a lower level of overlap with regard to the CRD requirements.

179. Cons: On the other hand, even this registration system would overlap with the CRD's provision on CRAs' recognition, though to a slightly lesser extent than in the previous option: in fact, there would be also in this case a partial duplication of accomplishments, controls and flows of information. Moreover, this system would imply a periodical check from CESR members of CRAs' compliance with the IOSCO Code, which would create an additional burden, both for CESR members and for the CRA's. If all CESR members were to perform monitoring activities that required active participation from the rating agencies, this could become quite a substantial burden for the agencies that were active on a European level.

## Option 3: Including the IOSCO Code within the CRD's recognition procedure

180. This regulatory option provides that the implementation of the IOSCO Code would be assessed in a parallel process to recognition within the CRD framework. In this case, the Competent Authorities in the CRD context should also assess, at a national level, the implementation of the IOSCO Code by CRAs before deciding about a recognition or the exclusion from it.

181. Pros: This option implies the presence of a consistent regulatory system, which would take advantage of simultaneous process in order to access credibility, stability, objectivity, independence and expertise of CRAs in the CRD context – and requirements related to the IOSCO Code, addressed to avoid conflicts of interest and to guarantee a fair behavior and a correct and exhaustive disclosure of rating and other information by CRAs.

182. Cons: On the other hand, this provision, by assessing the IOSCO Code paralleling the CRD framework, would bring regulation on rating only in the context of the ratings being used for the calculation of intermediaries' capital requirements. Moreover, this option would combine elements which are valid internationally, like those contained in the IOSCO Code, with the CRD's system which provides Competent Authorities for the option to have single national recognition and to ask, in the fulfillment of their monitoring activity, information to CRAs which are potentially different in each national context.

### Option 4: Third party's certification or enforcement of the IOSCO Code

183. This regulatory option provides that a third party certify or enforce the compliance of single CRAs' codes of conduct – which should be disclosed by the CRAs – with IOSCO Code of Conduct Fundamentals. This third party could be private or public (or semi-public): in the first case, it would "certify" the compliance with the IOSCO Code, whereas in the second case it would be an outside arbitration body to which market operators could apply, to obtain the enforcement of the IOSCO Code.

184. Pros: This option would leave the responsibility of establishing ways of implementing the IOSCO Code within the credit rating agencies, while on the other hand would introduce some kind of third party involvement in assessing the adherence of the disclosed code of conduct to the IOSCO Code.

185. Cons: A disadvantage might consist in the need to identify a really independent third party – whose function is quite relevant and demanding – and in the creation of a new subject playing a regulatory role, other than the existing ones.

### Option 5: Relying on rules covering only specific aspects of CRAs' activity

186. This option would involve the new provisions imposed under the future CRD. Specific rules proposed by CESR could also be applied where these addressed a clear market need.

187. Under this approach the IOSCO Code of Conduct would not be implemented via regulation. However, there are two ways to take its rules into account. The first is considering the Code in the context of self-regulation: the CRAs should then disclose to regulators and to the market their degree of implementation of the Code. The second is entrusting to the single national jurisdictions the decision about how to implement the Code at a national level (regulation or market mechanisms) and how to supervise compliance with its rules (regulatory oversight, outside arbitration body or market mechanisms).

188. Pros: Under this option the barriers to entry likely to be created by an additional registration regime or additional rules under the CRD would be avoided thereby reducing the risk of lowering competition within the market for credit ratings. Moreover, in the case of the IOSCO Code being taken into consideration in the context of self-regulation, the international activity of CRAs would find a correspondence with the disclosure of implementation of the Code's rules at a European level.

189. Cons: On the other hand, the regulation of rating would be less organic and more referred to specific issues. The implementation of the Code in a self-regulation framework could potentially be less strict than would be the case if it were directly included in European regulation. Moreover, if the implementation of the Code is entrusted to the national jurisdictions, there will be some provisions at the national level (the implementation of the Code, the monitoring activity related to recognition within the CRD framework), which could be different in each country.

### Option 6: Monitoring the market developments

190. The last alternative deals with the topic that markets are quite sufficient in working with the situation at the moment, as it was for example mentioned in the seminar of CESR's Task Force on CRAs on Oct. 08, 2004 by some market participants and some CRAs. Therefore it could be an option to do nothing at the moment, except to monitor developments related to CRAs, investors and issuers. Maybe after a certain period of time further measures (as described above) could be reconsidered. Additionally, it has to be taken into account that the IOSCO Code and the CRD do

include certain requirements for CRAs, thus it could be worth giving those provisions time to be implemented and then make a judgement about whether they are effective enough.

191. Pros: Without any further measures being imposed on CRAs there would not be additional regulation burdens. It could be one European aim to reduce the intervention of regulatory policy. Investors and issuers explained that there appear to be some problems with CRAs but, at the same time, they see an advantage for the quality of ratings in no regulatory interference, because otherwise the impression could arise that ratings are negotiated. In this case one could trust in the self regulation of the markets.

192. Cons: Not reacting to the power of the CRAs could result in an uncontrollable shift of power to the CRAs themselves, away from the investors and especially away from the issuers. Additionally the IOSCO code could become toothless if there is no enforcement (at least on a European level). It has also got to be taken into account that, for example, regulators still use ratings of external CRAs as one condition to define capital requirements in the banking and insurance sector.

Questions

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.

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

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

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

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

# ANNEXES TO THE CONSULTATION PAPER

# ANNEX A

EUROPEAN COMMISSION
Internal Market DG

Brussels,

## CALL TO CESR FOR TECHNICAL ADVICE ON POSSIBLE MEASURES CONCERNING CREDIT RATING AGENCIES

This call for technical advice to CESR follows the Commission commitments at the Oviedo Informal ECOFIN in April 2002, and in the European Parliament in February 2004, to examine the role of credit rating agencies.

In the European Parliament, the Commission identified four issues related to agencies. The Commission is now asking CESR to examine those four issues to the extent that they relate to its field of competence. Some of these issues have already been raised in the context of the Market Abuse Directive. As other issues may be linked to the Commission's Draft proposal on the review of capital requirements for banks and investment firms (CAD III), the Commission recommends that CESR works in collaboration with CEBS. The issues identified by the Commission are not exhaustive and CESR may wish to consider other relevant issues. CESR's examination of the issues and its subsequent advice should be based on an objective assessment of the situation, including any possible market failures and developments in the financial markets.

This call for technical advice to CESR will be made available on DG Internal Market's website.

Without prejudice to the Commission's right of initiative, the European Parliament called on the Commission to submit by 31 July 2005 its assessment of the need for appropriate legislative proposals to deal with this subject.

The requested deadline for delivery of CESR's technical advice is [1 April 2005].

## 1. BACKGROUND

The decision of the European Commission to provide CESR with a call for technical advice on credit rating agencies, for possible measures, was submitted to the European Securities Committee (ESC) on 5 July 2004. It follows the commitment made by the European Commission at the Informal ECOFIN in Oviedo in April 2002, after the collapse of Enron.

The Commission held an initial discussion on credit rating agencies in the ESC in May 2003. Delegations invited the Commission to take into account the work done by CESR on the Market Abuse Directive on financial research, in addition to the future Community rules for implementing Basle II.

A second discussion followed in September 2003, in the context of the draft Market Abuse Directive implementing measures, during which many ESC delegations requested that the Commission examine actively the issue of credit rating agencies in a broader context.

In February 2004, the European Parliament passed a resolution on the basis of MEP Katiforis' report on the role and methods of credit rating agencies. This report calls on the European Commission to submit by 31 July 2005 its assessment of the need for appropriate legislative proposals to deal with this topic.

Finally, in March 2004, following the Parmalat scandal and the European Parliament resolution adopted by an overwhelming majority, the Commission presented to the ESC the four core issues which it considers need to be addressed in relation to credit rating agencies, and which the Commission had also identified in the European Parliament debate in February:

(i) potential conflicts of interests within rating agencies;

(ii) transparency of rating agencies' methodologies;

(iii) legal treatment of rating agencies' access to inside information; and

(iv) concerns about possible lack of competition in the market for provision of credit ratings.

The technical advice delivered by CESR on the Market Abuse Directive might constitute a starting point on some aspects of the call for advice. However, as the role of credit ratings is being reinforced by developments in the Basle II banking legislation, the Commission recommends that CESR works in collaboration with CEBS.

The aim of the call is for CESR to provide the Commission with technical analysis and advice relating to the identified questions[11] in order for the Commission to assess the need, or not, for introducing European legislation or other solutions in this field.

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[1] Without prejudice to the competences of DG Competition of the European Commission on competition issues. For information, let us recall that on 12 March 2003, Commissioner Monti delivered a Commission's answer to European Parliament written question E-0044/03 regarding potential competition issues related to auditors and rating agencies.

In view of the commitment made by the Commission at the Oviedo Informal ECOFIN Council, the July 2005 deadline mentioned in European Parliament's resolution and the numerous public contributions already made on the topic, the Commission requests CESR's advice by [1 April 2005].

## 2. THE WORKING APPROACH AGREED BETWEEN DG INTERNAL MARKET AND THE EUROPEAN SECURITIES COMMITTEE

DG Internal Market of the Commission consulted the European Securities Committee on 5 July on its call for technical advice. At that meeting, it was agreed that CESR should start the work immediately, in collaboration with CEBS.

CESR should act in accordance with its normal consultation practices, consulting with market participants, consumers and end-users (as well as the other bodies specified in the call for advice) before it provides advice to the Commission.

Once the Commission has received CESR's report for technical advice, it will consider whether any European legislation or other solutions are needed.

## 3. CESR IS INVITED TO PROVIDE ADVICE ON AT LEAST THE FOLLOWING PRIORITY ISSUES BY [1 APRIL 2005]

In recognition of the fact that the largest credit agencies, and many companies that they rate, compete in global markets, CESR's work, to be carried out in collaboration with CEBS, should involve close contact with the United States Securities and Exchange Commission (SEC), which is currently working on this subject, in order to maximise the opportunity for the convergence of principles between the European and US regulatory approaches.

Another major dimension is the Basle II agreements. As these agreements will reinforce at international level the deployment of credit ratings into banking legislation, it seems crucial to consider this legal dimension when assessing the topic of credit rating agencies. In particular, due attention should be paid to the forthcoming Commission's Draft proposal on the review of capital requirements for banks and investment firms (CAD III).

A third dimension is discussions held in many public fora, including IOSCO, in recent years. A summary of these various initiatives is annexed to this call for advice.

### 3.1. TECHNICAL ADVICE RELATED TO THE ISSUE OF INTERESTS AND CONFLICTS OF INTEREST FOR CREDIT RATING AGENCIES

DG Internal Market requests that CESR provide technical advice on the major issues of interests and conflicts of interest for credit rating agencies and its views on the optimal regulatory ways to deal with them.

CESR

*(1) Technical advice related to the issue of provision of advisory/ancillary services by credit rating agencies*

The technical advice should at least take into account:

- the risk that the provision of advisory services by rating agencies to issuers they rate might influence the rating of these issuers;
- the possible consequent need to disclose, manage or prohibit such advisory services;
- the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards disclosure of interests and conflicts of interest for investment recommendations while recognising the differences between credit ratings and investment recommendations;
- the provisions of Article 13 paragraph 3 and Article 18 of European Parliament and Council Directive 2004/39/EC on markets in financial instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of those Articles. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of conflicts of interest foreseen for investment firms.

*(2) Technical advice related to the issue of payment for credit ratings to credit rating agencies by rated issuers*

The technical advice should at least take into account:

- the risk that payments for credit ratings to the rating agencies by subscribing issuers might influence the rating of these issuers;
- the possible consequent need to disclose the existence (but not the amount) of, or manage, such payments;
- the issue of unsolicited ratings turned into solicited;
- the possible consequent need to disclose, or manage, unsolicited ratings;
- the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards disclosure of interests and conflicts of interest for investment recommendations while recognising the differences between credit ratings and investment recommendations;
- the provisions of Article 13 paragraph 3 and Article 18 of European Parliament and Council Directive 2004/39/EC on markets in financial instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of those Articles. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of conflicts of interest foreseen for investment firms.

*(3) Technical advice related to the issue of capital links or any other interest links between rated issuers and credit rating agencies*

The technical advice should at least take into account:

- the risk that capital links (such as shareholdings or loans) or any other interest links between rated issuers and credit rating agencies might influence the rating of these issuers;

- the possible consequent need to disclose the existence of such links along with the rating;

- the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards disclosure of interests and conflicts of interest for investment recommendations while recognising the differences between credit ratings and investment recommendations;

- the provisions of Article 13 paragraph 3 and Article 18 of European Parliament and Council Directive 2004/39/EC on markets in financial instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of those Articles. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of conflicts of interest foreseen for investment firms.

### 3.2. TECHNICAL ADVICE RELATED TO THE FAIR PRESENTATION OF CREDIT RATINGS

DG Internal Market requests CESR to provide technical advice on whether measures are required to deal with the issue of fair presentation of credit ratings, including skills of agencies' staff and rating methodologies.

*(1) Technical advice related to the level of skills of agencies' staff*

The technical advice should at least take into account:

- the risk that lack of sufficient or inappropriate skills might lead to poor quality credit rating assessments;
- the possible consequent need to disclose or regulate such skills, taking into account an analysis of the relative risks of different regulatory and non-regulatory options;
- the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards the fair presentation of investment recommendations while recognising the differences between credit ratings and investment recommendations;
- the provisions contained in the Commission's proposed review of capital requirements for banks and investment firms; the provisions of Article 13 of European Parliament and Council Directive 2004/39/EC on markets in financial instruments, as well as CESR's current work on technical advice for possible implementing measures in respect of this Article. CESR shall ensure that its advice in respect of rating agencies is consistent with the treatment of organisational aspects, compliance and audit functions foreseen for investment firms.

*(2) Technical advice related to methodologies used for building credit ratings*

The technical advice should at least take into account:

- the risk that inappropriate, undisclosed or weak methodologies might lead to biased credit ratings or to biased interpretation of credit ratings;
- the possible consequent need to disclose or regulate such methodologies, taking into account an analysis of the relative risks of different regulatory and non-regulatory options;
- the provisions of Article 6 paragraph 5 of European Parliament and Council Directive 2003/6/EC ('Market Abuse Directive') and of Commission Directive 2003/125/EC implementing the Market Abuse Directive as regards fair presentation of investment recommendations while recognising the differences between credit ratings and investment recommendations;
- the provisions contained in the Commission's proposed review of capital requirements for banks and investment firms;
- the comparability of ratings within and across Member States for various categories of economic entities, with particular attention to SMEs.

### 3.3. TECHNICAL ADVICE CONCERNING THE RELATIONSHIP BETWEEN ISSUERS AND RATING AGENCIES

#### 3.3.1 Technical advice concerning the access to inside information from issuers by rating agencies

DG Internal Market requests that CESR provide technical advice on whether measures are required to deal with the issue of access to inside information from issuers by credit rating agencies.

*Technical advice related to the access to inside information by credit rating agencies*

The technical advice should at least take into account:

- the existing lack of clarity and harmonisation of legislation relating to access to inside information from issuers by rating agencies;
- the need to investigate appropriate measures to ensure that inside information is not inadvertently disseminated, selectively disclosed or misused in other ways;
- the need to ensure a level playing field between credit rating agencies;
- the provisions of Articles 1, 2, 3 and 6 of European Parliament and Council Directive 2003/6/EC (the Market Abuse Directive) and of Commission Directive 2003/124/EC implementing the Market Abuse Directive as regards the definition and public disclosure of inside information while recognising the differences between credit ratings and investment recommendations.

#### 3.3.2 Technical advice concerning other issues related to the relationship between issuers and rating agencies

DG Internal Market requests that CESR provide technical advice on whether measures are required to deal with other issues related to the relationship between issuers and rating agencies.

*Technical advice related to other issues concerning the relationship between issuers and rating agencies*

The technical advice should at least take into account:

- the need to ensure that issuers periodically have the opportunity to discuss with rating agencies the assumptions and fundamental determinants of their ratings;
- the need to ensure that information published by rating agencies (alongside rating opinions) is accurate and the role issuers are to play in such a process;
- the need for issuers to understand how rating agencies restate the figures they give them;

- the importance of rating agencies archiving all information related to a rating so that a rating decision can be explained to issuers at a later stage;

- the need for all rating agencies to have access to the same information from companies (rating agency data room).

### 3.4. TECHNICAL ADVICE RELATED TO POSSIBLE ENTRY BARRIERS TO THE MARKET FOR THE PROVISION OF CREDIT RATINGS

Any assessment of whether there might be a lack of competition, or concentration of market power, in the market for the provision of credit ratings, would fall within the competences of DG Competition of the Commission and does not form part of this call for advice. Nevertheless, DG Internal Market requests that CESR provide technical advice on whether there are entry barriers to this market that could be removed or alleviated.

***Technical advice related to availability of credit ratings and to the existence of possible entry barriers to the market for the provision of credit ratings***

The technical advice should at least take into account:

- whether there are any entry barriers to the market for credit ratings arising from regulatory requirements or otherwise and, if so, whether measures could/should be taken to reduce or remove any such barriers;

- the new framework for capital requirements for banks and investment firms;

- the coverage and availability of credit ratings in different Member States for various categories of economic entities, with particular attention to SMEs.

### 3.5. TECHNICAL ADVICE RELATED TO THE USE OF RATINGS IN EUROPEAN LEGISLATION AND IN PRIVATE CONTRACTS

European legislation makes use of ratings as a regulatory instrument. The proposed framework for capital requirements for banks and investment firms would extend the use of ratings in European legislation. From a technical point of view, does CESR consider that further use of ratings in European legislation should be encouraged beyond these measures?

Are there issues relating to the use of ratings in private contracts?

### 3.6. REGISTRATION

Taking account of 3.1-3.5 and on the basis of analysis on the financial markets – including any possible market failures – does CESR consider it appropriate that credit rating agencies should be registered in the EU? If so, how and under what type of regime, bearing in mind the need to avoid giving investors the impression of an absolute guarantee of quality of ratings?

EUROPEAN COMMISSION
Internal Market DG

# ANNEX TO THE CALL TO CESR FOR TECHNICAL ADVICE ON POSSIBLE MEASURES CONCERNING CREDIT RATING AGENCIES

This annex summarises the main strands of work underway internationally on credit rating agencies and which CESR is requested to examine during the preparation of its technical advice to the Commission.

## 1. EUROPEAN PARLIAMENT

### 1.1 European Parliament Resolution on role and methods of rating agencies

On 10 February 2004, the European Parliament (EP) adopted a Resolution on the role and methods of rating agencies, following an own-initiative report from its Committee on Economic and Monetary Affairs (Rapporteur: MEP Katiforis).

*Main features of the European Parliament resolution:*

- Calls upon the Commission to undertake all necessary steps, including in particular a cost-benefit analysis of the effects on European capital markets, to assess the establishment of a competent European Registration Scheme under the auspices of the Committee of European Securities Regulators (CESR) for the registration of rating agencies in Europe, conducted on the basis of well-specified, publicly advertised criteria involving credibility, objectivity, independence, expertise of staff, adequate funding, the existence of proper procedures for identifying and dealing with conflicts of interest and transparency of operations;

- Calls upon the Commission to maintain close contact with other securities market regulators and the International Organisation of Securities Commissions (IOSCO) to ensure that any developments in this area are globally consistent;

- Calls on the Commission and CESR to establish and maintain close contact with the US authorities on the conduct and outcome of their investigation;

- Calls for promotion of rating agencies which take greater account of the specific characteristics and needs of small and medium-sized enterprises;

- Regards specialisation of some rating agencies (in specific economic sectors or specific attributes of rated issuers) should not constitute any obstacle to their being treated on a level playing field with other rating agencies by regulatory authorities;

- Asks the Commission, CESR and the European Banking Committee to take into account the conclusions of the Financial Stability Forum, the IOSCO report on credit rating agencies and any reform of rating agency approval by the US SEC;

- Considers that rating agencies have public good objectives and should, therefore, report on their yearly activities and in particular on the financing of their rating activities;

- Favours inviting agencies to discuss setting up a voluntary industry body that would determine best practice, encourage training and provide a disputes and arbitration procedure for issuers or investors that felt aggrieved by the process leading up to an agency's decision;

- Wishes to oblige rating agencies to make public all their unsolicited ratings and to explain upon request any substantial difference between any unsolicited and subsequently solicited rating on the same debt or rated entity;

- Rejects the idea of regulating of content and opinions expressed by the agencies, stressing the need of agencies' independence from political or business influence, but does not reject regulation of process (whilst recognising the difficulty of drawing such a distinction);

- Wants issuers and debtors (that choose to be rated) to provide all relevant information on a permanent basis to rating agencies;

- Wants agencies to be transparent with regard to their methods, models and fees;

- Wants ratings users to disclose any rating triggers included in loan agreements in order to preserve the stability of markets;

- Asks the EU's competition authorities to consider any evidence of oligopoly;

- Calls on the Commission to submit, by 31 July 2005, its assessment of the need for appropriate legislative proposals to deal with the issues in the Parliament's Resolution and to ensure that any provisions adopted are consistent with the review of capital requirements for banks and investment firms (Basel II).

## 1.2 EP resolution on corporate governance and supervision of financial services – the Parmalat case

On 12 February 2004, the EP adopted a Resolution on corporate governance and supervision of financial services – the Parmalat case, following an own-initiative report.

In this resolution, the EP expressed the concern that among others, credit rating agencies had not raised the slightest suspicion that funds were being embezzled.

# 2. INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (IOSCO)

## 2.1 September 2003 report (including a 'Statement of Principles')

In September 2003, IOSCO released a report from its Technical Committee on the activities of credit rating agencies. The final section of this report consists of a Statement of Principles. This Statement of Principles covers the manner in which credit rating agencies activities should be conducted in order to reinforce the integrity of the rating process and to assist credit rating agencies in providing investors with informed and independent opinions.

The Chairman of the Task Force in charge of this Statement of Principles, Commissioner Roel Campos from the US Securities and Exchange Commission (SEC), stated in particular that these high-level principles – which focus more on objectives than methods or standards – will prove useful in all IOSCO jurisdictions, regardless of the legal systems and policy choices of the different IOSCO members.

The Statement makes clear that the manner in which these principles are given effect will depend upon local market circumstances and on each jurisdiction's legal system. In some cases, the principles may be best implemented through internal mechanisms within the credit rating agencies themselves and promoted by borrowers, lenders and other market participants. Alternatively, depending on the circumstances, the principles could be given effect through regulatory requirements.

As a result, according to the Statement, mechanisms for implementing the principles may take the form of any combination of government regulation, regulation imposed by non-government statutory regulators, industry codes and internal rating agency policies and procedures.

The Technical Committee of IOSCO proposed to await future consideration of these alternatives in the major jurisdictions and take account of preferences of other sector supervisors before considering its preferred method of implementation.

The Technical Committee proposed to review these developments within 18 months.

*Main features of the Statement of Principles:*

- Rating agencies should endeavour to issue opinions that help reduce the asymmetry of information between borrowers, lenders and other market participants (eg through rigorous methodologies, competent personnel);

- Rating decisions should be free from any political or economic pressure or conflict of interest (including ownership structure, business activities and employees' interests). Rating agencies should avoid circumstances that might compromise the independence and objectivity of credit rating activities, or they should manage and disclose them;

- Credit rating agencies should make disclosure and transparency an objective in their rating activities (eg transparency of procedures and methodologies, or whether a rating is unsolicited);

- Inside information should be maintained in confidence, through confidentiality agreements or mutual understandings.

### 2.2 Forthcoming IOSCO Code of Conduct for credit rating agencies (planned completion date: September 2004)

Following IOSCO's first initiative outlined above, some securities regulators and some rating agencies suggested that more specific and detailed guidance on how the principles laid down in the Statement of Principles should be implemented in practice would be useful. Therefore, IOSCO decided to develop a Code of Conduct for credit rating agencies, irrespective of legal and regulatory structures.

In May 2004, Commissioner Roel Campos from the US SEC and Chairman of the Task Force on this issue, stated that this Code of Conduct would be designed to address concerns surrounding how to ensure quality and integrity of rating processes, potential conflicts of interest, and comparability of 'track records' from different agencies by investors.

The Task Force plans to seek comment from the credit rating agency industry and the Basel Committee on Banking Supervision in June 2004. It will seek broader comment from the public, as well as interested governments, in July or August 2004.

The Task Force plans to complete the Code of Conduct by autumn 2004.

## 3. United States Securities and Exchange Commission (SEC)

Since 1975, the SEC has relied on credit ratings from "market-recognised credible" rating agencies in order to distinguish between grades of creditworthiness in various regulations under the federal securities laws. These agencies are recognized as "nationally recognised statistical rating organisations" (NRSROs) by the SEC through the no-action letter process. There are currently four NRSROs: Moody's Investors Service, Inc; Fitch, Inc; Standard and Poor's, a division of The McGraw-Hill Companies, Inc; and Dominion Bond Rating Service Limited (DBRS).

The initial regulatory use of the term "NRSRO" was solely to provide a method for determining capital charges on different grades of debt securities under the SEC Net Capital Rule for brokers-dealers, Rule 15c3-1 under the Exchange Act.

## 3.1 SEC Report on the role and function of credit rating agencies (January 2003)

Following the Enron collapse, the SEC submitted to Congress in January 2003 its Report on the role and function of credit rating agencies in the operation of securities markets in response to the Congressional directive contained in Section 702 of the Sarbanes-Oxley Act of 2002.

The report was designed to address each of the topics identified in Section 702, including the role of credit rating agencies and their importance to the securities markets; impediments faced by credit rating agencies in performing that role; measures to improve information flow to the market from credit rating agencies; barriers to entry into the credit rating business; and conflicts of interest faced by credit rating agencies. The report addressed additional issues such as allegations of anti-competitive or unfair practices; the level of due diligence performed by credit rating agencies when taking rating actions; and the extent and manner of SEC oversight of credit rating agencies.

## 3.2 SEC Concept Release on rating agencies and the use of credit ratings under the federal securities laws (June 2003)

On 4 June 2003, the SEC issued a Concept Release, submitted for public comments until 28 July 2003. This work was considered by the SEC as part of their review of the role of credit rating agencies in the operation of securities markets.

The SEC was seeking comment on several issues relating to credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes under US federal securities law and, if so, the process of determining whose credit ratings should be used, as well as the level of oversight that should be applied to such credit rating agencies.

The underlying aim was to find the appropriate degree of regulatory oversight that should be applied to credit rating agencies: between completely ceasing use of the NRSRO designation and rating agencies oversight, and implementation of a much more pervasive regulatory regime for credit rating agencies.

*Areas of questions presented by the SEC for public discussion:*

- NRSRO designation: advisability and feasibility of eliminating the NRSRO designation from the SEC's rules; which possible alternatives;
- Criteria for NRSRO recognition: need to change existing criteria and which possible alternative criteria;
- Examination and oversight of NRSROs: level of examination and need for ongoing oversight;
- Conflicts of interest: means of managing potential conflicts;
- Alleged anti-competitive, abusive and unfair practices: means of preventing them;
- Information flow: need and means for improving the quality of information available to users of credit ratings.

Following the end of consultation in July 2003, the SEC decided to reflect further on the subject.

## 4. G8 Declaration on 'Fostering Growth and Promoting a Responsible Market Economy' (June 2003)

In June 2003, during the G8 Evian summit, the G8 Declaration on 'Fostering Growth and Promoting a Responsible Economy' made reference to rating agencies.

*Statement from the G8 document 'Fostering Growth and Promoting a Responsible Market Economy':*

"Integrity, quality and accessibility are the cornerstones of reliable financial information. We call on all information providers – first and foremost companies and their auditors, as well as (…) rating agencies – to abide by these principles."

## 5. Organisation for Economic Co-operation and Development (OECD)

In April 2004, the governments of the 30 OECD countries approved a revised version of the OECD's Principles of Corporate Governance, adding new recommendations for good practice in corporate behaviour.

The initial Principles of Corporate Governance were adopted by OECD governments in 1999. It was decided that they should be revised in 2002, following a request from OECD governments for reinforcement of the Principles in response to then recent corporate scandals. A draft of the revised version was submitted to the public in January 2004.

These principles are non-binding, but they underpin the corporate governance component of the World Bank/IMF Reports on Standards and Codes (ROSC) and are part of the Twelve Key Standards for Sound Financial Systems named by the Financial Stability Forum.

In particular, the revised version calls on the corporate governance framework to be complemented by an effective approach that addresses and promotes the provision of analysis by rating agencies (among others) free from material conflicts of interest – identified under the form of provision of other services to the company, or of direct material interests in the company – that might compromise the integrity of their analysis. The preferred solution is to demand full disclosure of conflicts of interest and how the agency is choosing to manage them.

## 6. Association Française des Tresoriers d'Entreprise (AFTE) – Association of Corporate Treasurers (ACT) – Association for Financial Professionals (AFP)

### 6.1 Rating Agencies Survey by US AFP (November 2002)

In November 2002, the US Association of Financial Professionals, composed of 14 000 individual members working in the field of treasury and financial management, released a survey on rating agencies.

*Main result of the AFP survey:*

- 65% of corporate practitioners and 60% of financial industry service providers believe the SEC should clarify the procedures it uses for recognising rating agencies;

- 73% of corporate practitioners and 71% of financial industry service providers believe the SEC should periodically review the rating agencies it recognises;

- 56% of corporate practitioners and 63% of financial industry service providers believe that the recognition of additional rating agencies would improve ratings quality;

- 58% of corporate practitioners and 76% of financial industry service providers believe that the recognition of additional rating agencies would improve timeliness.

### 6.2 Code of Standard Practices for Participants in the Credit Rating Process (April 2004)

In April 2004, AFTE (from France), ACT (from the UK) and AFP (from the US) released an Exposure Draft of a "Code of Standard Practices for Participants in the Credit Rating Process". The aim of this code is to improve investor and issuer confidence in credit rating agencies and the judgements they promulgate in their reports. This draft was submitted for public comment until 30 June 2004.

When releasing the code, the AFP President made clear that this code is not a replacement for appropriate regulatory action. He added: "*Investors and corporations alike continue to be frustrated by the rating process while they wait for the regulators to act. It is time for the appropriate bodies to act on regulatory improvements that will encourage competition and transparency in the rating agency process. Regulatory action, along with the effective implementation of the Code of Standard Practices, will improve the effectiveness of the credit rating process and efficiency of capital markets.*"

The code includes recommendations addressed to regulators, credit rating agencies and debt issuers. The code is made up of three sections:

- regulatory recommendations;
- recommendations for a rating agency code of standard practices; and
- recommendations for a issuer code of standard practices.

*Main features of the joint AFTE/ACT/AFP Report:*

➢ Regulatory recommendations:

- Credibility and reliability of ratings: no prescription of rating agencies methodology by regulators, but requirement that every rating agency documents and adheres to its chosen, published methodology; requirement to disclose the date of the last formal review and of the last ratings update;
- Transparency in the rating agency recognition process and removal of barriers to competition: transparent, simple, stringent but attainable criteria for recognition or approval of rating agencies;
- Improvement of on-going regulatory oversight of approved rating agencies: regular review of each recognised agency;
- Inside information flows: regulators should require rating agencies to document and implement policies and procedures to prevent the selective disclosure of inside information (in particular where rating agencies are part of a wider organisation that might benefit from inside information) and prohibit former rating agencies analysts from taking positions in securities markets or working as journalists;

➢ Recommendations for a rating agency Code of Standard Practices:

- Improvement of the transparency of the rating process: public disclosure of methodology and of changes in methodology; public disclosure of the definition and historical default rates of each rating symbol used; public disclosure of the qualification and sector coverage of the analyst concerned;
- Protection against conflicts of interest: ownership structure unlikely to create conflicts of interest; strong Chinese walls between rating analysts and agency staff

responsible for raising revenue from solicited ratings; strong Chinese walls between rating analysts and staff involved in providing rating advisory services;

- Address the issue of unsolicited ratings: explicit mention of 'solicited' or 'unsolicited' nature of the rating; explicit mention of the participation of the issuer in the rating process; explicit mention of discussions with the issuer prior to the rating decision or of the use of non-public information to build the rating;

- Disclosure of the date when a rating was last updated: along with the date of the last full review with the issuer (not less than one year as a principle);

- Improvement of communication with issuers and other market participants: review by issuers of accuracy of reported information prior to public release; disclosure by the rating agency to the issuer of the key assumptions and fundamental analysis underlying the rating decision; right of appeal by the issuer, including to the rating committee or through an outlook from a new group of analysts; recording of information related to the issuer for a sufficient period;

➢ <u>Recommendations for an Issuer Code of Standard Practices</u>:

- Minimum list of information to provide to rating agencies: business strategy, legal and management structure and processes, business environment, risk management and financing, any material change in the financial situation;

- Full review between rating agency and issuer at least once a year;

- Information of rating agency by issuer ahead of launching any corporate actions;

- Fast answer to rating agency requests;

- No pre-emptive action to challenge or counter the release, during the period where rating agencies submit communications to the issuer prior to their public release;

- Not taking advantage of a delay in the release of a rating by making any debt issuance other than the refinancing of maturing short-term debt.

CESR

# ANNEX B

## Summary of responses to CESR's call for evidence

### General comments

The nature of the reactions differ considerably. Some of the answers contain basically general remarks, whilst a number of market participants have made very detailed comments, sometimes in connection with previous consultations undertaken by other bodies. Some of the responses have not followed the points as included in the call for advice from the Commission but instead focus on the particular issues of concern for the respondent, thus making it somewhat difficult to draw conclusions as to what a particular sector as a whole thinks of a certain issue.

All the respondents coincide in welcoming the European Commission's initiative to study the role credit rating agencies play in the European capital market, as they stress the growing importance to the market and regulators of the rating agencies. Given the relevance of this work, a concern for the tight timetable set for CESR to provide its technical advice, together with a complaint for the lack of time for market participants to develop high quality input, has also been put forward by some respondents.

In addition, most of the responses point out that given the global nature of the markets in which the CRAs and the companies they rate operate, there is a need to ensure a common worldwide approach on this subject and, therefore, support a close co-ordination between the different regulators. These respondents consider that previous works, more specifically those developed by the SEC and by IOSCO, need to be taken into consideration by CESR when preparing its advice. Contact with CEBS is also encouraged.

The existence of these previous works on CRAs is reflected on the fact that many of the responses are quite detailed and already point out several possible policy options that have been analysed under the abovementioned initiatives. There are even some answers that seem focused on comments to those papers and make reference to concepts, such as the American NRSRO, that have not been introduced in the call for evidence.

Although some respondents consider regulatory action to be necessary in this area, most of the commentators show a clear preference for market driven solutions based on professional standards, code of conducts and similar non-regulatory procedures. They consider that any attempt to regulate the rating activity, in particular to prescribe methodologies or processes, is likely to compromise the independence of rating agencies, reduce innovation and quality of the process and, consequently, undermine the value to users of rating opinions. Among those who support regulatory actions, most believe that regulation should be restricted to the provision of a general framework and should not deal with the details and methodology of the rating process.

Some of the respondents have pointed out similarities in the activities performed by rating agencies and those carried out by research firms conducting equity research. These respondents believe that both activities should essentially be subject to the same rules and regulations, taking into account, when formulating the individual requirements and standards, the minor differences that might exist. On the other hand, other respondents show their concern to the fact that the Commission's mandate refers to the Market Abuse and Investment Services Directives, since they believe that no analogy should be drawn between the rating agency industry and those companies that provide investment recommendations. In their view CESR should be aware of the substantial differences between both activities.

In addition, one response requests the inclusion in CESR's advice of the activities performed by Credit Assessment Agencies in the belief that the role and importance of these companies, specially for small-medium size enterprise that are not rated by CRA due to their size or the cost, should also be taken into consideration.

### Interest and conflicts of interest

Most respondents agree on the fact that potential conflict of interest might arise on the three aspects highlighted in the mandate: advisory services, payment by issuers and capital links between rated issuers and CRAs. However, most of them consider that the real impact of these conflicts is in practice very small and has already been satisfactorily dealt with by the CRAs operating in the market through code of conducts. In their opinion, firewalls set for the different activities in most internal codes and the practice of disclosing the fees are sufficient tools to solve any potential conflict of interest that might appear. Nevertheless, some responses propose to prohibit or limit the possibility of CRAs to perform activities besides ratings and most commentators believe disclosure of all the aspects concerning possible conflicts of interest should be required.

### Fair presentation of credit ratings

Most respondents dislike the possibility of imposing regulatory criteria as to rating methodologies and processes and believe disclosure obligations on this should be enough. In addition, some respondents have shown a great concern on this subject, as they consider that regulatory action would erode individual quality and independence of the rating agency's credit analysis and would have a detrimental effect on the quality of information flow in securities markets.

Concerning the aspect of the level of skills of agencies staff, although a few respondents consider that provisions should be set to require specific initial and continuous training and one even proposes that a specific degree should be required (chartered rating analyst), most believe this to be an internal issue that CRAs should deal with.

### Relationship between issuers and CRAs

Most respondents consider that the issue of access to non-public information by CRAs is an important aspect that should be analysed in detail. Some believe that more clarity and legal harmonisation is desirable with respect to access to inside information from CRAs, others advocate for requiring organisational measures to prevent the unintended, selective or abusive use and publication of this information and, finally, others consider that CRAs have already satisfactorily solved this problem in their code of conducts.

Concerning the cooperation of issuers with CRAs, most commentators believe that a fluid dialogue between issuers and CRAs, during the process of preparation of the rating and afterwards, is the best way to ensure that the result of the work performed by the CRAs is the most accurate one. However, some responses highlight the need to make sure that issuers do not inappropriately influence the rating decision.

### Possible entry barriers to the market for provisions of credit rating

Respondents recognise that limited competition exists today in the credit rating industry and, in general, are of the view that additional competition would have a beneficial effect on the market. Specifically, a few commentators manifested their concerns regarding possible anti-competitive actions taken by the largest CRAS. One respondent proposed to encourage measures that could prompt equity research firms to expand their operations into credit ratings, in order to introduce more competence in the market. The fact that excessive regulation of CRAs could lead into more entry barriers besides the natural barrier that exist, has also been highlighted in some responses.

## Use of rating in European legislation and in private contracts

Not many respondents have made comments on this specific item. Among those who have answered, one believes that further use of ratings in European legislation should be encourage, whilst the rest consider that it is preferable not to use ratings in legislation or regulation where the regulatory objectives can be met by some other technique. Among these, some point out the danger of regulation of major spheres of economic activity being transferred from public authorities to private institutions, which might not be subject to sufficient control.

Regarding the use of ratings in private contract, there was a general support for the idea that it should be up to the parties to the contract to negotiate appropriate arrangements taking into account proper principles of risk management. However, the disclosure of the existence of such triggers to ratings is encouraged.

## Registration

Only a few responses focus on this subject. There are split views on this matter since, whilst some consider registration as a good option, others are not in favour of including a registration requirement and others do not currently have a preference regarding the establishment of a registration procedure.

## Respondents to the Call for Evidence

Banking

AFC Consulting
Barclays
Data Conversion Specialists, Inc.
DVFA
EACT
EFFAS
Fédération Bancaire de l'Union Européenne
HypoVereinsbank
ICAP A.E.
Investment Management Association
Zentraler Kreditausschuss

Credit Rating Agencies

Dominion Bond Rating Service
Egan Jones Rating Company
Fitch Ratings
Moody's Investors Service
Slovak Rating Agency
Standard and Poors

Government, regulatory & enforcement

Austrian Federal Economic Chamber

Individuals

Kathleen McElvogue
Olivier Raingeard

Insurance, pension & asset management

Association of British Insurers
Prudential plc

Investment services

Barclays PLC
Bond Market Association
ISMA

Investors relations

Absreports.com
French Society of Financial Analysts

Issuers

AFEP
The Association of Corporate Treasurers

Regulated markets, exchanges & trading systems

Warsaw Stock Exchange

CESR

# ANNEX C

## Code of Conduct Fundamentals for Credit Rating Agencies

OICU-IOSCO

A Consultation Report of the Chairmen's Task Force
of the Technical Committee of the
International Organization of Securities Commissions

October 2004

**PREAMBLE**

The Chairmen's Task Force of the Technical Committee of the International Organization of Securities Commissions has published for public consultation this Consultation Report on *Code of Conduct Fundamentals for Credit Rating Agencies.* The public is invited to submit comments on this Consultation Report by November 8, 2004. Instructions regarding the submission of comments are set out below.

In September 2003, the IOSCO Technical Committee issued a Statement of Principles Regarding the Activities of Credit Rating Agencies (CRAs). These CRA Principles laid out high-level objectives that CRAs, regulators, issuers and other market participants should strive toward in order to protect the integrity and analytical independence of the credit rating process. The Consultation Report follows on the CRA Principles by offering more specific and detailed guidance to CRAs on how the objectives of the CRA Principles can be achieved in practice.

*The CRA Code of Conduct Fundamentals* are designed to be a set of measures that should be included in some form or fashion in the codes of conduct of individual CRAs. As currently drafted, these measures are not intended to be rigid or formulistic: when incorporating these measures into their own codes of conduct, CRAs will be able to maintain a degree of flexibility to deal with the different legal and market circumstances in which they operate. However, it is envisioned that securities regulators may decide to incorporate the *CRA Code of Conduct Fundamentals* into their own regulatory oversight of CRAs, may decide to oversee compliance of the *CRA Code of Conduct Fundamentals* directly, may decide to provide for an outside arbitration body to enforce the *CRA Code of Conduct Fundamentals*, or may rely on market mechanisms to enforce compliance if an individual CRA's own code of conduct fails to adequately address the provisions outlined by the *CRA Code of Conduct Fundamentals*.

In developing the Consultation Report, the Chairmen's Task Force sought input from the CRA industry, the Basel Committee of Banking Supervisors, and the International Association of Insurance Supervisors. The Consultation Report will be revised and finalized after consideration of all comments received from the public. In seeking public comment, the Chairmen's Task Force is particularly interested in views of how the provisions contained within the *CRA Code of Conduct Fundamentals* advance the goals of investor protection, fairness, efficiency and transparency in securities markets, and the reduction of systemic risk.

In addition to the Consultation Report itself, the Chairmen's Task Force also seeks public comment on two separate issues:

> 1. Whether it is *advisable* to require CRAs disclose to issuers beforehand changes to their rating methodologies and rating criteria and whether such a requirement would enhance or undermine investor protection. Such a provision might take the form of a revised Provision 3.9:
>
> *Because users of credit ratings rely on an existing awareness of CRA practices, procedures and processes, the CRA should fully and publicly disclose modification of these practices, procedures and processes <u>prior to these modifications going into effect</u>. The CRA should carefully consider the various uses of credit ratings before modifying its practices, procedures and processes.* [Underlined language added.]
>
> 2. How compliance with the *CRA Code of Conduct Fundamentals* should be best enforced, given different legal and market circumstances in different jurisdictions. The current draft recognizes that different jurisdictions may adopt different mechanisms to help ensure compliance. Proposals within this framework include direct regulatory oversight, an outside arbitration body (such as the International Chamber of Commerce) that would determine whether a CRA is in compliance with the *CRA Code of Conduct Fundamentals*, as well as market mechanisms. The public is invited to opine on which of these approaches (as well as others) are better suited to achieving the objectives of protecting investors, maintaining fair, efficient and transparent markets, and reducing systemic risk.

After the consultation process, the Chairmen's Task Force will submit a final version of the CRA Code of Conduct Fundamentals to the IOSCO Technical Committee for approval.

## How to Submit Comments

Comments may be submitted by one of three methods. To help us process and review your comments more efficiently, please use only one method.

***Important:*** *All comments may be made available to the public.*

### 1. E-mail

- Send comments to mail@oicv.iosco.org.
- The subject line of your message must indicate "Public Comment on *Code of Conduct Fundamentals for Credit Rating Agencies.*"
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc.) to create the attachment.
- DO NOT submit attachments as HTML, PDF, GIF, TIFF, PIF, ZIP, or EXE files.

OR

### 2. Facsimile Transmission

Send by facsimile transmission using the following fax number: 34 (91) 555 93 68.

OR

### 3. Paper

Send 3 copies of your paper comment letter to:

Philippe Richard
IOSCO Secretary General
Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a "Public Comment on *Code of Conduct Fundamentals for Credit Rating Agencies.*"

CESR

## CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

### INTRODUCTION

Credit rating agencies (CRAs) can play an important role in modern capital markets. CRAs typically opine on the credit risk of issuers of securities and their financial obligations. Given the vast amount of information available to investors today – some of it valuable, some of it not – CRAs can play a useful role in helping investors and others sift through this information, and analyze the credit risks they face when lending to a particular borrower or when purchasing an issuer's debt and debt-like securities.[1]

In September 2003, IOSCO's Technical Committee published a Statement of Principles Regarding the Activities of Credit Rating Agencies. The Principles were designed to be a useful tool for securities regulators, rating agencies and others wishing to articulate the terms and conditions under which CRAs operate and the manner in which opinions of CRAs should be used by market participants. Because CRAs are regulated and operate differently in different jurisdictions, the Principles laid out high-level objectives that rating agencies, regulators, issuers and other market participants should strive toward in order to improve investor protection and the fairness, efficiency and transparency of securities markets and reduce systemic risk. The Principles were designed to apply to all types of CRAs operating in various jurisdictions. However, to take into account different market, legal and regulatory circumstances, the manner in which the Principles were to be implemented was left open. The Principles contemplated that a variety of mechanisms could be used, including both market mechanisms and regulation.

Along with the Principles, IOSCO's Technical Committee also published a Report on the Activities of Credit Rating Agencies that outlined the activities of CRAs, the types of regulatory issues that arise relating to these activities, and how the Principles address these issues. The CRA Report highlighted the growing and sometimes controversial importance placed on CRA assessments and opinions, and found that, in some cases, CRAs activity is not always well understood by investors and issuers alike. Given this lack of understanding, and because CRAs typically are subject to little formal regulation or oversight in most jurisdictions, concerns have been raised regarding the manner in which CRAs protect the integrity of the rating process, ensure that investors and issuers are treated fairly, and safeguard confidential material information provided them by issuers.

Following publication of the CRA Principles, some commenters, including a number of CRAs, suggested that it would be useful if IOSCO were to develop a more specific and detailed code of conduct giving guidance on how the Principles could be implemented in practice. The following Code of Conduct Fundamentals for Credit Rating Agencies is the fruition of this exercise. As with the Principles, with which it should be used, the CRA Code Fundamentals were developed out of discussions among IOSCO members, CRAs, representatives of the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, issuers, and the public at large. The CRA Code Fundamentals offer a set of robust, practical measures that serve as a guide to and a framework for implementing the Principles' objectives. These measures are the fundamentals which should be included in individual CRA codes of conduct, and the elements contained in the CRA Code Fundamentals should receive the full

[1] CRAs typically provide credit ratings for different types of debts and financial obligations — including, for example, private loans, publicly and privately traded debt securities, preferred shares and other securities that offer a fixed or variable rate of return. For simplicity's sake, the term "debt and debt-like securities" is used herein to refer to debt securities, preferred shares, and other financial obligations of this sort that CRAs rate.

support of CRA management and be backed by thorough compliance and enforcement mechanisms. However, the measures set forth in the CRA Code Fundamentals are not intended to be all-inclusive: CRAs and regulators should consider whether or not additional measures may be necessary to properly implement the Principles in a specific jurisdiction, and the Technical Committee may revisit the CRA Code Fundamentals in the future should experience dictate that modifications are necessary. Further, the CRA Code Fundamentals are not designed to be rigid or formulistic. They are designed to offer CRAs a degree of flexibility in how these measures are incorporated into the individual codes of conduct of the CRAs themselves, according to each CRA's specific legal and market circumstances. However, in developing their own codes of conduct, CRAs should keep in mind that securities regulators may decide to incorporate the CRA Code Fundamentals into their own regulatory oversight, may decide to supervise compliance with the CRA Code Fundamentals, and/or may decide to provide for an outside arbitration body to enforce the CRA Code Fundamentals. Jurisdictions may also rely on market mechanisms to enforce compliance with the CRA Code Fundamentals, as the market may judge a CRA adversely if its own code of conduct fails to address the provisions contained in the CRA Code Fundamentals.

Finally, the CRA Code Fundamentals address measures that CRAs should adopt to help ensure that the CRA Principles are properly implemented. The CRA Code Fundamentals do not address the equally important obligations issuers have of cooperating with and providing accurate and complete information to the marketplace and the CRAs they solicit to provide ratings. While aspects of the CRA Code Fundamentals deal with a CRA's duties to issuers, the essential purpose of the CRA Code Fundamentals is to promote investor protection by safeguarding the integrity of the rating process. IOSCO members recognize that credit ratings, despite their numerous other uses, exist primarily to help investors assess the credit risks they face when making certain kinds of investments. Maintaining the independence of CRAs vis-à-vis the issuers they rate is vital to achieving this goal. Provisions of the CRA Code Fundamentals dealing with CRA obligations to issuers are designed to improve the quality of credit ratings and their usefulness to investors. These provisions should not be interpreted in ways that undermine the independence of CRAs or their ability to issue timely ratings opinions.

Like the IOSCO CRA Principles, the objectives of which are reflected herein, the CRA Code Fundamentals are also intended to be useful to all types of CRAs relying on a variety of different business models. The CRA Code Fundamentals do not indicate a preference for one business model over another, nor are the measures described therein designed to be used only by CRAs with large staffs and compliance functions. Accordingly, the types of mechanisms and procedures CRAs adopt to ensure that the provisions of the CRA Code Fundamentals are followed will vary according to the market and legal circumstances in which the CRA operates.

Structurally, the CRA Code Fundamentals are broken into three sections and draw upon the organization and substance of the Principles themselves:

- The Quality and Integrity of the Rating Process;
- CRA Independence and the Avoidance of Conflicts of Interest; and,
- CRA Responsibilities to the Investing Public and Issuers.

## TERMS

The CRA Code Fundamentals are designed to apply to any CRA and any person employed by a CRA in either a full-time or part-time capacity. A CRA employee who is primarily employed as a credit analyst is referred to as an "analyst."

For the purposes of the CRA Code Fundamentals, the terms "CRA" and "credit rating agency" refer to:

- Those entities whose primary business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers or debt and debt-like securities; or

- Any organization whose ratings are recognized for regulatory purposes by a financial regulatory authority.

For the purposes of the CRA Code Fundamentals, a "credit rating" is an opinion forecasting the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system. As described in the CRA Report, credit ratings are not recommendations to purchase or sell any security.

## THE IOSCO CODE OF CONDUCT REGARDING THE ACTIVITIES OF CREDIT RATING AGENCIES

As described in the IOSCO CRA Principles, CRAs should endeavor to issue opinions that help reduce the asymmetry of information that exists between borrowers and debt and debt-like securities issuers, on one side, and lenders and the purchasers of debt and debt-like securities on the other. Rating analyses of low quality or produced through a process of questionable integrity are of little use to market participants. Stale ratings that fail to reflect changes to an issuer's financial condition or prospects may mislead market participants. Likewise, conflicts of interest or other undue factors – internal and external – that might, or even appear to, impinge upon the independence of a rating decision can seriously undermine a CRA's credibility. Where conflicts of interest or a lack of independence is common at a CRA and hidden from investors, overall investor confidence in the transparency and integrity of a market can be harmed. CRAs also have responsibilities to the investing public and to issuers themselves, including a responsibility to protect the confidentiality of some types of information issuers share with them.

To help achieve the objectives outlined in the CRA Principles, which should be read in conjunction with the CRA Code Fundamentals, CRAs should adopt, publish and adhere to a Code of Conduct containing the following measures:

### 1. QUALITY AND INTEGRITY OF THE RATING PROCESS

### A. Quality of the Rating Process

1.1 *The CRA should adopt, implement and enforce written procedures and methodologies to ensure that the opinions it disseminates are based on a thorough analysis of all relevant information available to the CRA.*

1.2 *The CRA should use rating methodologies that are rigorous, systematic, and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience.*

*1.3 In assessing an issuer's creditworthiness, analysts involved in the preparation or review of any rating action should use methodologies established by the CRA.*

*1.4 Credit ratings should be assigned by the CRA and not by any individual analyst employed by the CRA; ratings should reflect all public and non-public information known, and believed to be relevant, to the CRA; and the CRA should use people who, individually or collectively have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied.*

*1.5 The CRA should maintain internal records to support its credit opinions for a reasonable period of time or in accordance with applicable law.*

*1.6 The CRA and its analysts should take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of an issuer or obligation.*

*1.7 The CRA should ensure that it has and devotes sufficient resources to carry out high-quality credit assessments of all obligations and issuers it rates. When deciding whether to rate or continue rating an obligation or issuer, it should assess whether it is able to devote sufficient personnel with sufficient skill sets to make a proper rating assessment, and whether its personnel likely will have access to sufficient information needed in order make such an assessment.*

*1.8 The CRA should structure its rating teams to promote continuity and avoid bias in the rating process.*

B. Monitoring and Updating

*1.9 Except for "point in time" ratings that clearly indicate they do not entail ongoing surveillance, once a rating is published, the CRA should monitor on an ongoing basis and update the rating by:*

*a. regularly reviewing the issuer's creditworthiness;*

*b. initiating a review of the status of the rating upon receipt of any information that might reasonably be expected to result in a rating action (including termination of a rating); and,*

*c. updating on a timely basis the rating, as appropriate, based on the results of such review.*

*1.10 Where a CRA makes its ratings available to the public, the CRA should publicly announce if it discontinues rating an issuer or obligation. Continuing publications by the CRA of the discontinued rating should indicate the date the rating was last updated and the fact that the rating is no longer being updated. Where a CRA's ratings are provided only to its subscribers, the CRA should announce to its subscribers if it discontinues rating an issuer or obligation. Continuing publications by the CRA of the discontinued rating should indicate the date the rating was last updated and the fact that the rating is no longer being updated.*

C. Integrity of the Rating Process

*1.11 The CRA and its employees should comply with all applicable laws, rules and regulations governing its activities in each jurisdiction in which it operates.*

*1.12 The CRA and its employees should deal fairly and honestly with issuers, investors, other market participants, and the public.*

*1.13 The CRA's analysts should be held to high standards of integrity, and the CRA will not employ individuals with demonstrably compromised integrity.*

*1.14 The CRA and its employees should not, either implicitly or explicitly, give issuers any assurance or guarantee of a particular rating prior to a rating assessment.*

*1.15 The CRA should institute policies and procedures that clearly specify a person responsible for the CRA's and the CRA's employees' compliancewith the provisions of the CRA's code of conduct and with applicable laws and regulations. This person's reporting lines and compensation should be independent of the CRA's rating operations.*

*1.16 Upon becoming aware that another employee or entity associated with the CRA is or has engaged in conduct that is illegal, unethical or contrary to the CRA's code of conduct, a CRA employee should report such information immediately to the individual in charge of compliance or an officer of the CRA, as appropriate, so proper action may be taken. Its employees are not necessarily expected to be experts in the law. Nonetheless, its employees are expected to report the activities that a reasonable person would question. Any CRA officer who receives such a report from a CRA employee is obligated to take appropriate action, as determined by the laws and regulations of the jurisdiction and the rules and guidelines set forth by the CRA.*

## 2. CRA Independence and Avoidance of Conflicts of Interest

### A. General

*2.1 The CRA and its analysts should use care and professional judgment to maintain both the substance and appearance of independence and objectivity.*

*2.2 The determination of a credit rating should be influenced only by factors relevant to the credit assessment.*

*2.3 The CRA should not forbear or refrain from taking a rating action based on the potential effect (economic, political, or otherwise) of the action on the CRA, an issuer, an investor, or other market participant.*

*2.4 The credit rating a CRA assigns to an issuer or security should not be affected by the existence of or potential for a business relationship between the CRA (or its affiliates) and the issuer (or its affiliates) or any other party, or the non-existence of such a relationship.*

2.5 *The CRA should separate its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest.*

### B. CRA Procedures and Policies

*2.6 The CRA should adopt written internal procedures and mechanisms to (1) identify, and (2) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest* *that may influence the opinions and analyses CRAs make or the judgment and analyses of the individuals the CRAs employ who have an influence on ratings decisions. The CRA's code of conduct should also state that the CRA will disclose such conflict avoidance and management measures.*

*2.7 The CRA's disclosures of actual and potential conflicts of interest should be complete, timely, clear, concise, specific and prominent.*

*2.8 The CRA should disclose the general nature of its compensation arrangements with rated entities. Where a CRA receives from a rated entity compensation unrelated to its rating service, such as compensation for consulting services, the CRA should disclose the proportion such non-rating fees constitute against the fees the CRA receives from the entity for ratings services.*

*2.9 The CRA and its staff should not engage in any securities or derivatives trading presenting conflicts of interest with the CRAs ratings activities.*

*2.10 In instances where rated entities (e.g., governments) have, or are simultaneously pursuing, oversight functions related to the CRA, the CRA should use different employees to conduct its rating actions than those employees involved in its oversight issues.*

C. CRA Analyst and Employee Independence

*2.11 Reporting lines for CRA employees and their compensation arrangements should be structured to eliminate or effectively manage actual and potential conflicts of interest. The CRA's code of conduct should also state that a CRA analyst will not be compensated or evaluated on the basis of the amount of revenue that the CRA derives from issuers that the analyst rates or with which the analyst regularly interacts.*

*2.12 The CRA should not have analysts initiate, or participate in, discussions regarding fees or payments with any entity they rate.*

*2.13 No CRA employee should participate in or otherwise influence the determination of the CRA's rating of any particular entity or obligation if the employee:*

*a. Owns securities or derivatives of the rated entity or any related entity thereof;*

*b. Has had an employment or other significant business relationship with the rated entity within the previous six months;*

*c. Has an immediate relation (i.e., spouse, partner, parent, child, sibling) who currently works for the rated entity; or*

*d. Has, or had, any other relationship with the rated entity or any agent of the rated entity that may be perceived as presenting a conflict of interest.*

*2.14 The CRA's analysts and anyone involved in the rating process (or members of their immediate household) should not buy or sell or engage in any transaction in any security or derivative based on a security issued, guaranteed, or otherwise supported by any entity within such analyst's area of primary analytical responsibility, other than holdings in diversified mutual funds.*

*2.15 CRA employees should be prohibited from soliciting money, gifts or favors from anyone with whom the CRA does business and should be prohibited from accepting gifts offered in the form of cash or any gifts exceeding a minimal monetary value.*

*2.16 Any CRA analyst who becomes involved in any personal relationship that creates the potential for any real or apparent conflict of interest (including, for example, any personal relationship with an employee of a rated entity or agent of such entity within his or her area of analytic responsibility), should be required to disclose such relationship to the appropriate manager or officer of the CRA, as determined by CRA compliance policies.*

3. CRA RESPONSIBILITIES TO THE INVESTING PUBLIC AND ISSUERS

A. Transparency and Timeliness of Ratings Disclosure

*3.1 The CRA should distribute in a timely manner its ratings decisions regarding the entities and securities it rates.*

*3.2 The CRA should publicly disclose its policies for distributing ratings and reports.*

*3.3 Except for "private ratings" provided only to the issuer, the CRA should disclose to the public, on a non-selective basis and free of charge, any rating regarding publicly issued securities, or public issuers themselves, as well as any subsequent decisions to discontinue such a rating, if the rating action is based in whole or in part on material non-public information.*

*3.4 The CRA should publish sufficient information about its procedures, methodologies and assumptions so that outside parties can understand how a rating was arrived at by the CRA. This information will include (but not be limited to) the meaning of each rating category and the definition of default and the time horizon the CRA used when making a rating decision.*

*3.5 When issuing a rating, CRAs should explain in their press releases and reports the key elements underlying their rating decision.*

*3.6 Where feasible and appropriate, prior to issuing or revising a rating, the CRA should advise the issuer of the critical information and principal considerations upon which a rating will be based and afford the issuer an opportunity to clarify any likely factual misperceptions or other matters that the CRA would wish to be made aware of in order to produce an accurate rating. The CRA will duly evaluate the response.*

*3.7 In order to promote transparency and to enable the market to best judge the performance of the ratings, the CRA, where possible, should publish sufficient information about the historical default rates of CRA rating categories and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category and if and how ratings categories have changed, and be able to draw quality comparisons among ratings given by different CRAs. If the nature of the rating or other circumstances make a historical default rate inappropriate, statistically invalid, or otherwise likely to mislead the users of the rating, the CRA should explain this.*

*3.8 The CRA should disclose when its ratings are not initiated at the request of the issuer and whether the issuer participated in the rating process.*

*3.9 Because users of credit ratings rely on an existing awareness of CRA practices, procedures and processes, the CRA should fully and publicly disclose modification of these practices,* *procedures and processes. The CRA should carefully consider the various uses of credit ratings before modifying its practices, procedures and processes.*

B. The Treatment of Confidential Information

*3.10 The CRA should adopt procedures and mechanisms to protect the confidential nature of information shared with them by issuers under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially. Unless otherwise permitted by the confidentiality agreement or required by applicable laws or regulations, the CRA and its employees should not disclose confidential information in press releases, through research conferences, to future employers, or conversations with investors, other issuers, or other persons, or otherwise.*

*3.11 Where a CRA is made aware of non-public information of the kind required to be disclosed under applicable laws and regulations, depending on the jurisdiction, the CRA may be obligated to make this information available to the public. However, prior to doing so, the CRA should indicate to the issuer its intent to release this information and permit the issuer to immediately disclose this information itself. The timeframe a CRA should provide an issuer to make this disclosure should be limited.*

*3.12 The CRAs should use confidential information only for purposes related to their rating activities or otherwise in accordance with their confidentiality agreements with the issuer.*

*3.13 CRA employees should take all reasonable measures to protect all property and records belonging to or in possession of the CRA from fraud, theft or misuse.*

*3.14 CRA employees should be prohibited from engaging in transactions in securities when they possess confidential information concerning the issuer of such security.*

*3.15 In preservation of confidential information, CRA employees should familiarize themselves with the internal securities trading policies maintained by their employer, and periodically certify their compliance as required by such policies.*

*3.16 CRA employees should not selectively disclose any non-public information about rating opinions or possible future rating actions of the CRA.*

*3.17 CRA employees should not share confidential information entrusted to the CRA with employees of any affiliated entities that are not CRAs. CRA employees should not share confidential information within the CRA except on an "as needed" basis.*

*3.18 CRA employees should not use or share confidential information for the purpose of trading securities, or for any other purpose except the conduct of the CRA's business.*

4. DISCLOSURE OF THE CODE OF CONDUCT

*4.1 The CRA should disclose to the public its code of conduct and describe how the provisions of its code of conduct are consistent with the provisions of the IOSCO Principles Regarding the Activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. The CRA should also describe generally how it intends to implement and enforce its code of conduct and disclose on a timely basis any changes to its code of conduct or how it is implemented and enforced.*

CESR

# ANNEX D

## SUMMARY OF RESPONSES TO CESR'S QUESTIONNAIRE ON CRAS ADDRESSED TO ITS MEMBERS

One of the principal sources used by CESR in order to understand the issues related to CRAs' activities has been a questionnaire that IOSCO circulated among its members as part of the research undertaken prior to the publication in September 2003 of its Report on the Activities of Credit Rating Agencies.

Notwithstanding the foregoing, CESR decided relatively earlier in its work, to circulate among its members an amended version of the IOSCO questionnaire. The aim of this exercise was to obtain a full understanding of the CRAs' operations in all EU jurisdictions, some of which were not covered by the IOSCO survey. Also several questions were added, as some of the issues included in the Commission's call for advice were not fully addressed by the IOSCO questionnaire.

As the CESR questionnaire only focused on the abovementioned issues/jurisdictions not covered by the IOSCO one, the conclusions drawn from the latter are fully valid for CESR work unless otherwise stated in this summary. Said conclusions are summarized in section III of the IOSCO Report on the Activities of Credit Rating Agencies[7].

The following is a summary of the key points derived from the responses to the CESR questionnaire on CRAs.

### 1. General: CRAs' operations in the EU

In most countries, the three largest international CRAs (Moody's, S&P and Fitch) are the only CRAs doing business. However, a few jurisdictions have a number of smaller competing CRAs as well.

The rating process used by the largest CRAs is described in Section IV of the abovementioned IOSCO report. Concerning the methodologies of the small CRAs operating in the EU, they take qualitative and quantitative rating criteria into account. It is not easy to assess the real size of their operations but they seem to have difficulties in being able to provide a large number of ratings to the public, even after several years of operation.

### 2. Market failures

Before initiating its study, the task force wanted to find out whether there is evidence of any events where CRAs' performance had not met the expectations of the market. The questionnaire responses showed overall, that CESR members are not aware of major failures in the way the rating industry is operating. There are some exceptions, as there are cases where CRAs have been criticised for being too slow to react to market events, Parmalat being the most notorious one. CRAs have also been accused of being late in announcing changes in rating methodology and criteria. Finally, there are complaints that CRAs issue favourable ratings to key clients.

### 3. Difficulties or problems that issuers have experienced in their relationship with CRAs

The CESR Task Force found that there have been reproaches for a lack of understanding of local differences in key rating aspects such as management style, culture, legal framework, lack of availability of analytical resources and access to analysts, lack of transparency with regard to rating terms and conditions, arbitrary pricing policy, and lack of coordination with the legally required market communication.

[7] Available on IOSCO website http://www.iosco.org/pubdocs/pdf/IOSCOPD153.pdf

## 4. Oversight

The majority of CESR members indicated that no particular government agency in their jurisdiction exercises oversight authority over CRAs as such. Notwithstanding, in certain countries credit ratings are used in particular areas of securities regulation, such as public offers of securities or securitizations. In these cases, the securities regulators exercise supervision over CRAs' activities regarding only the issues where credit ratings are mandatory according to the relevant legislation. In addition, some CESR members indicated that CRAs operating in their jurisdictions are subject to a variety of securities and financial regulations, particularly those governing disclosure and use of information.

## 5. Registration

In most CESR members' jurisdictions, CRAs are not required to register.

## 6. Users of CRA ratings

The description of the use of ratings by the different market participants as described in item 3 of the summary of the responses to the IOSCO questionnaire is fully applicable to the EU market. The CESR questionnaire adds more information in relation to the use of ratings by regulators and some more detail to the use of ratings by issuers.

### Issuers

The responses to the questionnaire indicated that credit ratings are used by issuers not only for pricing securities or marketing purposes. There are also some ancillary uses of ratings by issuers for management purposes. Ratings are especially important for large or mid-sized corporations or municipalities that are seeking access to bond markets for the first time. In these cases, the rating is considered a useful "passport" for accessing global pools of capital.

The questionnaire also asked whether issuers are required to include published ratings in their mandatory disclosure requirements. Several responses highlighted that issuers would be obliged to disclose the rating in case it would fall under the definition of inside information. In addition, some jurisdictions require issuers to disclose the rating assigned in bond prospectuses.

### Regulators

Financial regulators in many EU jurisdictions appear to use credit ratings for a variety of purposes. These uses vary from setting capital requirements for banks and other financial institutions to rules governing the investments of money market funds and collective investment schemes, and in regulating public offers of asset-backed securities. Also, supervisors of insurance companies use ratings in different ways, such as for calculation of their technical reserves, to determine eligible counterparties or in the context of stress testing that insurance companies are obliged to apply.

## 7. Regulatory Recognition Criteria

While credit ratings are frequently used for certain regulatory purposes, there are differences in how specific CRAs are recognized for these purposes. Some jurisdictions impose no recognition criteria. Other CESR members recognize (on either a formal or informal basis) a certain number of CRAs for regulatory purposes.

Where CRAs are used for regulatory purposes, CESR members base their recognition decisions on a variety of criteria, such as credibility with international or domestic market participants; independence; demonstration that the CRA appropriately manages real and potential conflicts of interest; availability of ratings to domestic and foreign institutions; minimum personnel proficiency and training requirements; minimum resource (staff and financial) requirements. Finally, another factor considered is that the CRA's rating methodology must be transparent, rigorous, systematic and subject to validation based on historical experience.

## 8. Barriers to Market Entry

CESR findings are fully consistent with the conclusions of the IOSCO Report on the activities of CRAs (item 5 of the summary of the responses to the IOSCO questionnaire).

## 9. Availability of Credit Ratings

From the responses to the CESR questionnaire, it seems that SMEs are not frequent users of credit ratings in the EU. Apparently, this is not due to a lack of willingness from the CRAs to rate this category of issuers. The more likely explanations, according to the responses from CESR members, are the relatively low access by SMEs to the bond markets and the proportionally higher rating fees that they would have to pay.

## 10. Ratings Disclosure and Publication; Rating methodologies and Transparency; CRA and CRA Staff Compensation

The conclusions of the IOSCO report (items 6, 7 and 8 of the summary of the responses to the IOSCO questionnaire) are also applicable to the EU market.

In addition, the European Commission has raised in its call for advice to CESR the issue of the need that all rating agencies have access to the same information from companies. Although it seems that not all CRAs have access to the same information from issuers, CESR members are not aware that this is a matter that some CRAs or other market participants are complaining about.

## 11. Conflicts of interest

The potential areas where conflicts of interest may arise, cited by CESR members, coincide with the analysis of the IOSCO report (item 9 of the summary of the responses to the IOSCO questionnaire) which is therefore also applicable to the EU market.

Overall, in most EU jurisdictions the safeguards intended to address the potential conflicts of interest are a matter of industry practice only.

## ANNEX E
Use of ratings in private contracts

## 1. IOSCO Report on the activities of credit rating agencies, including a 'Statement of Principles' (September 2003)

When analyzing the responses provided in relation to the question on whether private parties use ratings assigned by CRAs in financial agreements or other private contracts, the following summary is included: *"Creditors and other businesses may use CRA ratings in private contracts for a variety of purposes. Among the most prominent of these uses are "ratings triggers" in financial contracts. In many secured or structured financial agreements, counterparties and lenders are given the right to accelerate repayment of an outstanding loan, or have the borrower post collateral, if the rating of the borrower's fixed-income securities falls below a certain level. Counterparties and lenders sometimes demand these clauses in order to help them secure collateral and recover prospective losses in cases where a borrower faces a serious likelihood of bankruptcy or default".*

## 2. UNITED STATES SECURITIES AND EXCHANGE COMMISSION (SEC)

Among other aspects, the use of ratings in private contracts in the US market was studied in the **SEC Report on the role and function of credit rating agencies.** The paragraphs dealing with this issue are the following:

*"The extensive use of credit ratings in private contracts also has enhanced the importance of credit ratings to the marketplace. For example, the widespread use of "ratings triggers" in financial contracts recently has received considerable attention as a result of certain high-profile bankruptcies, such as Enron and Pacific Gas and Electric Company ("PG&E"). In the case of Enron, the use of credit ratings as "triggers" in trading and other financial agreements gave counterparties the right to demand cash collateral, and lenders the right to demand repayment of outstanding loans, once Enron's credit rating declined to certain levels. As a result, the existence of ratings triggers contributed to Enron's financial difficulties. similarly, the impact of credit rating downgrades on PG&E's financial agreements limited its ability to borrow funds to repay its short term debt obligations. In cases such as these, contractual ratings triggers can seriously escalate liquidity problems at firms faced with a deteriorating financial outlook. As noted in Section V below, because of the significant potential negative impact of contractual ratings triggers on issuers, the Commission intends to explore whether issuers should be required to provide more extensive public disclosure regarding such triggers. In addition, credit rating agencies and others have been conducting intensive studies to better understand the nature and extent of the use of credit ratings in financial contracts, and their potential impact on a company's liquidity and creditworthiness."*

*"In the course of our study, concerns were expressed about the level of public disclosure by issuers. At the Commission's credit rating agency hearings, several specific areas for improved issuer disclosure were mentioned, including the need for additional detail regarding an issuer's short-term credit facilities and, particularly in light of the Enron experience, better disclosure of the existence and nature of "ratings triggers" in contracts material to an issuer. In essence, "ratings triggers" are contractual provisions that terminate credit availability or accelerate credit obligations in the event of specified rating actions, with the result that a rating downgrade could lead to an escalating liquidity crisis for issuers subject to ratings triggers. Given the potentially catastrophic impact ratings triggers could have on an issuer, disclosure of their existence both to rating agencies and the public would appear critical. In the aftermath of the Enron bankruptcy, the rating agencies appear to have become more diligent in seeking information regarding ratings triggers. Nevertheless, as noted in Section V below, the Commission is exploring whether additional*

*issuer disclosures should be required, including disclosures relating to the existence and impact of ratings triggers."*

*"Shortly after the Enron bankruptcy, several of the larger credit rating agencies surveyed a number of U.S. and European companies to determine their exposure to ratings triggers. According to the published surveys, the rating agencies indicated that few companies appeared to be exposed to a high degree of risk on account of ratings triggers, other than those previously known to them. In addition, some companies and lenders appear to have acknowledged that the use of ratings triggers can backfire and precipitate a liquidity crisis and, accordingly, are beginning to remove ratings triggers from their agreements."*

Following the commitment of further study included in its report, the SEC included in its Concept Release a specific question on whether additional issuer disclosures relating to the existence and impact of ratings triggers should be required (question 55).

## 3. European Central Bank: Occasional paper series (Nº. 16/June 2004): "Market dynamics associated with credit ratings. A literature review"

This paper summarizes the work conducted by a group of economists from various European central banks with the intention of adding to the ongoing debate on major rating agencies and their methodologies.

The analysis and policy considerations proposed are based on a review of the literature and are those of the authors; they do not necessarily reflect the positions of their respective institutions.

The paper is aimed at contributing to the current debate on this topic by providing a factual exposition of the significance and evolving use of credit ratings in the financial markets and by identifying the possible impacts that such evolving use may have on market dynamics.

Under the section devoted to the analysis of the consequences of the widespread use of ratings, an analysis of rating triggers is provided in the following terms.

*"Ratings-based triggers are intended to protect lenders against credit deterioration and asymmetric information problems, and lenders are willing to pay for triggers by accepting lower spreads/coupons. Hence, there is a clear demand-side reason for issuing debt instruments with embedded rating triggers.*

*There is, however, also a supply-side reason for rating triggers: i.e. borrowers are willing to include such triggers because without them lenders would probably demand a higher initial spread on debt contracts. Rating triggers attempt to offer protection to investors, but, due to the way in which they work, they could precipitate a liquidity crisis and/or even contribute to extreme events such as bankruptcies.*

*The inclusion of rating triggers in debt contracts is not new. The so-called "super poison put provisions", for example, that gained prominence in bonds issued in late 1980s, following the RJR Nabisco buyout, contained embedded rating triggers. A super poison put provision allows bondholders to sell their bonds to the issuing company at par value or at a premium after the occurrence of a "designated event" combined with a "qualifying downgrade". Hence, super poison put provisions can be viewed as conditional rating triggers, conditional on a specific event or a set of events. The exact provisions varied from issue to issue, creating uncertainty about the strength of the protection offered in any particular bond issue. In response to this uncertainty, S&P began rating the event risk protection of bonds with put provisions in July 1989.*

*The designs of ratings-based triggers vary, both in form and in the identity of the contracting parties. In general, a rating trigger provides creditors and counterparties with certain rights in the* *event of a borrower's credit rating falling to, or below, a specified level. The rights given to the creditors usually vary from an increase in the nominal coupon to a put option.*

*According to a recent survey by Moody's (2001), out of 771 US corporate issuers rated Ba1 or higher, only 12.5% reported no triggers, while the remaining 87.5% reported a total of 2,819 rating triggers. Not only did rating triggers appear to be widely used, but situations in which a single issuer was subject to multiple triggers were common at the time of the survey. While there are reasons to believe that the use of such features has since declined, no comprehensive picture is available that would help to accurately assess the current situation.*

*The table below shows common features of rating triggers and their frequency.*

**Table**

| Trigger | | Frequency |
|---|---|---|
| Collateral, letter of credit, bonding provisions | | 21.6% |
| Pricing grid | | 21.1% |
| Acceleration | | 29.1% |
| *of which* | *Termination* | *8.5%* |
| | *Material adverse change* | *5.4%* |
| | *Default* | *5.3%* |
| | *Acceleration* | *4.0%* |
| | *Put* | *3.0%* |
| | *Early amortisation* | *2.9%* |
| Other | | 28.2% |

Source: Moody's Investors Service (2001).

*As can be seen in this table, contingency clauses are diverse in nature, and hence their consequences, if activated, may be wideranging:*
*• Collateral, L/Cs and bonding provisions are clauses that are usually written into bank loan agreements. When the clause is triggered, the mechanism does not result in a change in the initial financing conditions but*
*requires the borrower to pledge assets to guarantee its financing over time. Hence, the impact of the triggered clause should mainly be on the opportunity cost of capital.*
*• Pricing grids or adjustments in interest rates or coupons are features found both in bonds and in bank loans where the initial interest rate or coupon is revised in the event of a change in the borrower's rating (or in some of its financial ratios). The impact of the exercised trigger is a mechanical increase in the cost of capital.*
*• Acceleration clauses may have more severe, or sometimes even critical, effects. For example, for a loan or bond initially issued for a long period, the triggering of the clause may result in an acceleration of repayments*
*or even early termination of credit. As mentioned above, these types of clause are used both in bond contracts and in bank loan agreements as well as in back-up credit lines. Not only does the triggering of a clause result in an increase in the cost of capital, but also in an immediate need for new capital.*

*Two major problems associated with rating triggers are worth highlighting:*
*• Rating triggers can contribute to "credit cliff" situations. "Credit cliff" is market jargon for a situation in which dire consequences, i.e. compounding credit deterioration, possibly leading to default, may be expected should certain risk scenarios materialise. In this regard, S&P has stated that "in these cases, if there is a rating change, it will necessarily be a very substantial change (due to) the entity's greater sensitivity to credit quality or a particular occurrence." This can put material pressure on the company's liquidity or its business. For example, when downgraded, the position of a company that is performing poorly will worsen as its cost of capital rises. Rating triggers and*

*other covenants, particularly when combined, can contribute to the development of such credit cliffs and may speed up the pace at which the cost of capital increases due to credit deterioration. This is especially the case in situations where multiple triggers are set off simultaneously, or when the triggering of one clause leads to an accumulation of negative consequences. It is not clear how CRAs take these situations into account. Bonds rated at the lowest investment-grade notch (where traditionally a large proportion of these rating triggers have been found) tend to suffer large price falls when they are downgraded. Owing to the above mentioned risks of self-fulfilling effects, the presence of rating triggers may reinforce the finding that rating agencies are only willing to decide on a rating action when it is unlikely to be reversed shortly afterwards.*

*• <u>Disclosure of ratings-based triggers by issuers has until recently been incomplete and largely ignored by analysts and investors</u>. Present accounting standards leave a significant degree of discretion as to whether triggers need to be disclosed. Under US (GAAP/FAS), UK (FRS) and international accounting standards (IAS) there is an obligation to disclose material triggers, but material in this context means not only that the contingent obligation is large, but that it potentially has a significant bearing on the company's financial situation. For instance, these requirements do not appropriately address situations where an issuer/borrower has included many "nonmaterial" triggers in its debt covenants/bond issues. However, if there is uncertainty as to whether the company is a going concern, there should be a clear obligation to disclose. Nonetheless, it has proved difficult to obtain a comprehensive picture of the size of the contingent liability of triggers, despite the fact that this information is crucial for investors as well as analysts and rating agencies in order to fully apprehend the risks attached to a specific issue or issuer.*

*Efforts have been made in this area, notably under pressure from rating agencies, to encourage a more systematic disclosure of rating triggers and to renegotiate and smooth the more dangerous ones. A survey by S&P in 2002 among more than 1,000 US and European investment-grade debt issuers revealed that about half of these issuers were exposed to some sort of ratings-linked contingent liability. However, fewer than 3% exhibited serious vulnerability to rating triggers or other contingent calls on liquidity which could turn a moderate decline in credit quality into a liquidity crisis.*

*Transparency and disclosure are important features that could help mitigate some of the negative aspects of rating triggers and other contingency clauses. It is unlikely that systematic (mandatory) disclosure of rating triggers and greater transparency with regard to exposure to rating triggers could prevent rating events from disturbing markets once the triggers are activated, but it could increase the awareness of the situation in the market and promote a longer-term view on the part of market participants. The same holds true for covenants based on balance sheet ratios.*

*Furthermore, the present context of incomplete transparency and disclosure of rating triggers may be seen as impacting on the price discovery mechanism of fixed income products (and, by extension, equities) as it results in an additional risk premium associated with this "rating trigger" uncertainty. This in turn may lead to a higher cost of capital and higher yields than would have been the case under a more transparent framework. Thus, the "benefits" of these clauses are not fully exploited. However, if rating triggers were systematically disclosed from their inception, this information would be priced in from the start in bond issues (and stocks) and the number of triggers used in debt issues of any single borrower would probably be more limited. Moreover, it could also be argued that the expected benefits (for issuers) from these devices would prove illusory, as the relative prices of the various debt instruments of an issuer/borrower and its equity price would adjust to reflect the existence of rating triggers in some debt instruments, and that the benefits (in terms of favourable financing conditions) stemming from trigger-carrying instruments would be offset by deteriorating financing conditions (and increased volatility) for "unprotected" instruments. It is, of course, unlikely that all rating triggers could be disclosed, since there are private placements and bank loan agreements with embedded options. Still, greater transparency should have both direct and indirect positive effects on credit markets."*

## 4. Credit rating agencies studies on the use of credit ratings in financial contracts, and their potential impact on a company's liquidity and creditworthiness

Following several cases of deterioration in the creditworthiness of important companies that highlighted the significant role of rating triggers in the viability and value of debt instruments, several of the larger credit rating agencies surveyed a number of U.S. and European companies to determine their exposure to ratings triggers.

A brief summary of the main conclusions of these surveys is provided below.

**a) "The Unintended Consequences of Ratings Triggers," Moody's Global Credit Research (December 2001).**

In this report Moody's identifies various forms of rating triggers and describes how they work, when they are employed, and how they can have unexpected – and sometimes highly disruptive consequences for issuers and creditors alike. The following is a summary opinion of the main aspects dealt with in the paper:

• Rating triggers are increasingly being incorporated into loan agreements, indentures, and financial contracts. This is often done to the detriment of the creditors who intend to be protected by these triggers, as well as the borrowers who provided them. Investors who think they might be protected by a rating trigger contained in their respective contract may find - as in recent cases - that there is no protection because the trigger can potentially cause a default or bankruptcy adversely affecting all creditors.
• The presence of rating triggers may result in downward rating pressure depending on the severity of the triggers, the underlying facts and circumstances surrounding the credit, and the rating level of the issuer.
• Rating triggers can result in a precipitous decline in confidence and liquidity. Rating triggers intended to set-off default, acceleration, or "puts" in back-up credit lines, bond indentures, and counterparty agreements are particularly risky. For example, a back-up revolving credit that goes away or a large bond that is puttable in the event of a downgrade below a certain level, are potentially very negative in a difficult scenario. The loss of liquidity when a downgrade occurs may be stressful for the borrower, precisely at the time when the company is least able to deal with an associated loss of investor confidence. Such triggers can be highly destabilizing because all parties may not behave in a rational fashion.
• Moody's intends to identify, where possible, the existence of rating triggers in each issuer's financial structure, to examine whether those issuers whose agreements contain particularly risky rating triggers have the wherewithal to survive a downgrade to the specified trigger level and the consequences of the trigger.

**b) Special Comment, "Moody's Analysis of US Corporate Rating Triggers Heightens Need for Increased Disclosure," Moody's Global Credit Research (July 2002).**

In connection with the previous report and as part of Moody's stepped-up approach to the analysis of rating triggers, Moody's undertook a comprehensive review of all rating triggers. In December 2001, Moody's asked nearly 1,900 US corporate issuers of rated debt to provide a list of all rating triggers contained in all "on-balance sheet" and "off-balance sheet" financial arrangements whether rated or not rated, as well as triggers included in contracts covering other agreements with third parties. The request was made to all issuers irrespective of rating and amount of rated debt. In addition, the issuers were asked to reference the amount of debt involved and the possible effect of each rating trigger.

The main findings are summarized below:

• Rating triggers vary in severity of impact from benign to severe. The study determined that a large proportion of triggers consist of a requirement to reset pricing (pricing grids) which in Moody's views is relatively benign. On the other end of the risk spectrum there are triggers that cause a loss of availability under credit lines, events of default, acceleration or "puts". The liquidity implications of these rating triggers can be severe since such triggers exacerbate liquidity strains at the precise moment when an issuer is least able to deal with such problems.

• Rating triggers are most often used in agreements for low investment grade and crossover credits, and the most consequential rating triggers which result in default, acceleration, early amortization or puts often occur when a company's ratings fall below Investment Grade.

• A very low percentage of triggers were disclosed in the SEC filings of the responding issuers. Nearly 87.5% of responding companies whose debt is rated Ba1 or higher reported that they had rating triggers. According to information supplied by these companies, only 22.5% of the triggers were disclosed in their SEC filings. In addition, it has to be pointed out that some of the most problematic triggers may not be disclosed as more than half of the disclosed triggers related to pricing grids.

• In view of the importance of rating triggers, Moody's will highlight, where possible, the existence of these in each issuer's financial structure. Although Moody's will not disclose the particulars of any undisclosed triggers due to confidentially constraints, it intends to factor the effects of each rating trigger (whether or not publicly disclosed by the issuer) into the rating. In addition the issuer's refusal to provide information about its rating triggers to Moody's will be considered a negative factor in the ratings process.

**c) "Rating Triggers in Europe: Limited Awareness but Widely Used Among Corporate Issuers," Moody's Special Comment, September 2002.**

In this report Moody's tries to answer the question of how widespread are rating triggers in Europe. Moody's asked 345 European corporate debt issuers to provide a list of all rating triggers contained in both "on-balance sheet" and "off-balance sheet" financial arrangements whether rated or not, as well as triggers included in contracts or other arrangements with third parties.

Moody's general conclusion was that rating triggers were indeed widely used in Europe and that their reporting was unsystematic and that there was only a limited awareness of their dangers. As more detailed conclusions, the following can be highlighted:

• Rating triggers are less omnipresent in Europe than in the United States, but still common. Moody's identified rating triggers among 59% of respondents, compared with 87.5% of respondents in the above survey conducted in the United States.

• Among European issuers, rating triggers are prominent among the mid to low investment grade category. Approximately two-thirds of the 157 issuers reporting triggers were in the Ba1 to A2 range.

• Few rating triggers are found in the non-investment grade sector. Within non-investment grade, rating triggers are primarily used in swap agreements or bond indentures. The purpose is primarily to ward off potential acquisition by an entity with a weaker credit profile.

• In Europe there are selected industries where rating triggers are used more widely than others. For example, rating triggers are widely used in the energy and utility sector relative to sectors such as food and retail.

**d) "Survey on Rating Triggers, Contingent Calls on Liquidity", Standard and Poor's, 2002.**

In 2002 S&P conducted a survey among more than 1,000 US and European investment-grade debt issuers. The survey revealed that around 50% of these issuers were exposed to some sort of ratings-linked contingent liability. However, less than 3% have serious vulnerability to rating triggers or other contingent calls on liquidity which could turn a moderate decline in credit quality into a liquidity crisis.

**e) FITCH survey (2002).**

Fitch conducted a survey in 2002 to assess how widespread such ratings-based triggers were in loan documents and found that ratings triggers were generally not part of the leveraged and high-yield loan market, but were fairly common in investment grade syndicated loans.